Bus Admin

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THE JOURNAL OF Taxation

NATIONAL JOURNAL OF CURRENT NEWS & COMMENT FOR PROFESSIONAL TAX MEN

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NEW DEVELOPMENTS IN

Fraud & negligence

EDITED BY HARRY GRAHAM BALTER, LL.B.

When should the taxpayer refuse to give his books to the IRS?

by **HARRY GRAHAM BALTER**

Perhaps the most difficult, and most fateful, decision a tax man ever is called on to make is whether or not to advise his client under investigation to refuse to make his books and records available to the Service. Mr. Balter considers here the legal rights of individuals, partnerships and corporations, notes the complications when third parties have possession of records and, weighing the intangible but oftentimes extremely important disadvantages of refusing access, concludes with a rule for the one time that access should be refused.*

WE ARE CONCERNED with the not uncommon situation where an investigation or audit is being conducted by a revenue agent alone or jointly with a Special Agent, and the taxpayer has a substantial basis for fearing that facts may be discovered which may reveal fraudulent tax returns have been filed. The taxpayer's books are available, but if they are examined closely they may reveal damaging information either as relates to a deficiency in tax or to fraudulent intent.

Treasury agents have almost unlimited access to the books and records of third persons with whom the taxpayer has dealt.[1] Here we are centering our discussion on the taxpayer's own books and records. Some key problems are evident:

1. Does the particular taxpayer involved in the investigation have the legal right to refuse the agents access to his books and records if that be his decision?

2. Is the situation any different if the taxpayer's books are physically in the possession of his accountant, his attorney, or some other third party?

3. What are the disadvantages to the taxpayer if he refuses access to his books? and finally,

4. Under what circumstances may it be preferable for the taxpayer to refuse to turn over his books regardless of the known consequences flowing from such refusal?

Assume for the moment that in other respects we are dealing with a taxpayer who, under the applicable circumstances, has a legal right to refuse to turn over his books and records, what are the basic or general principles which underlie the taxpayer's right to refuse access?

Where it would appear that the result of the investigation would end only in civil tax liability no matter how extensive the deficiency and no matter how onerous additional civil penalties may be, the taxpayer would have no legal right to refuse access to his books. But if his books and records would "tend to incriminate" him, that is, it is likely that based on what the books would reveal criminal charges could be brought against him, the taxpayer would have the legal right to refuse access.

Generally speaking, the courts have been very liberal on the issue of whether his books may tend to incriminate the taxpayer. A reasonably clear showing is adequate. The showing need be neither convincing nor conclusive. The taxpayer also has been aided by the "link in the chain" principle, on the basis of which evidence would be held to "tend to incriminate" the taxpayer even if by itself it would seem to involve no criminalty, as long as the evidence may lead to other evidence which, when taken together, reasonably may become the basis for criminal charges against the taxpayer.[2]

Normally, where a Special Agent, a revenue agent acting jointly with a Special Agent, or a revenue agent attached to a so-called "fraud squad" is making the investigation, this situation would be sufficient to justify the taxpayer in refusing access to his books. If this refusal is made timely and unequivocably under these circumstances, the agents rarely will attempt to enforce their demands for the taxpayer's books, but will continue their efforts to complete their case by other means, usually concentrating on obtaining secondary evidence, or evidence from third parties whose records would reflect income-producing transactions with the taxpayer.[3]

The right to refuse access to books and records, however, is affected directly by the form in which the taxpayer does business—which may be corporation, partnership, or sole proprietorship. Let us take them in order.

Corporations

It is settled that a corporate taxpayer can claim no self-incrimination immunity. Therefore, access to its records may not be refused on that ground.[4] The same rule applies to an unincorporated association, as well.[5] However, a corporate taxpayer may urge the protection of the Fourth Amendment against unreasonable searches and seizures where repeated requests for access to records under the circumstances would seem to be unreasonable.[6]

The nonapplicability of the self-incrimination principle to a corporate taxpayer has important practical ramifica-

* This article is based on a presentation made by the author at the Eighth Annual Marquette University Institute on Taxation held at Milwaukee on October 16-18, 1957. Mr. Balter has practiced law in Los Angeles since 1926. He has been a frequent writer and lecturer on tax subjects, including two text books: FRAUD UNDER FEDERAL TAX LAW and FEDERAL RULES OF CIVIL PROCEDURE; and numerous articles which have appeared in TAXES, JOURNAL OF TAXATION (of which he is a department editor), the PRACTICAL LAWYER, the AMERICAN BAR ASSOCIATION JOURNAL, and the JOURNAL OF THE STATE BAR OF CALIFORNIA, among others. He has lectured at Tax Institutes sponsored by New York University (Twelfth Annual and Fourteenth Annual); Missouri State Bar; Utah State Bar; University of Southern California; University of Denver; National Society of Public Accountants; Marquette University (Seventh Annual and Eighth Annual) and Washington State Society of CPAs.

[1] Balter, FRAUD UNDER FEDERAL TAX LAW (2nd Ed. 1953), p. 152 *et seq.*

[2] Hoffman v. U. S., 341 U.S. 479 (1951); Redlich, *Searches, Seizures, and Self-Incrimination in Tax Cases*, 10 TAX L. REV. 191 (1955); Kostelanetz and Bender, CRIMINAL ASPECTS OF TAX FRAUD CASES (1957), p. 49.

[3] Ibid, p. 35 *et seq.*

[4] Wilson v. United States, 220 U.S. 311 (1911).

tions. Here is a fairly common situation: A and B do business as C corporation. A Special Agent and a revenue agent are investigating tax returns of C corporation. A and B prepared and signed C's returns as corporate officers. The agents suspect fraud in the corporate returns in that there would appear to be substantial unrecorded corporate sales. They also suspect that the receipts from these sales were distributed to A and B directly without first having been recorded in C's books. The Special Agent may recommend criminal action as follows:

1. Against C, the corporation.
2. Against A and B for causing a false return to be filed by the corporation.
3. Against A individually for filing his own personal false return, and
4. Against B individually for filing his own personal false return.

The key to all of these recommendations as far as the Special Agent is concerned would be the books and records of the corporation. Access to them may not be refused by A and B even though criminal charges may follow against A and B individually.[7] Of course, A and B may refuse to talk to the agents or to make any oral statements.

In spite of the lack of constitutional protection, however, strategy may dictate refusal to turn over the corporate records to either the agent (on the Commissioner's summons) or to the Grand Jury on its subpoena, for the following practical considerations:

1. A court may refuse to enforce a Grand Jury subpoena on the basis that fair play (if not the law) requires that the agent resort to the Commissioner's summons in order to commandeer the corporate records.[8]

2. Before enforcing the Commissioner's summons as to the "closed" years (barred by the statute of limitations in the absence of fraud), the Special Agent would be compelled by affidavit or by oral testimony to satisfy the court that there is a reasonable basis for suspecting fraud. This testimony may help reveal what the agents are driving at, and may be of material aid in preparing the taxpayer's defenses.

But a corporate officer who fails to obey an ultimate court order to honor the legal process commandeering the corporate records runs the risk of being jailed for contempt.[9]

Partnerships

Immunity extends to the books and records of the normal partnership, since the aggregate rather than the entity theory of the nature of a partnership still holds in this respect.[10] This is probably true even where the partnership records would incriminate one partner but not others.[11] Whether immunity would extend to the books and records of extensive operations, such as a limited partnership with many investors, syndicates, subdivision joint ventures, and the like, which would seem to have the trappings of corporate or association entities, may be open to some question.[12]

Sole proprietorship

It is settled that the taxpayer doing business as an individual may refuse access to his own books and records on constitutional grounds.[13]

A cloud has been cast over this settled principle on the basis of the implications of the decision of the Supreme Court in the case of *Shapiro*,[14] which held that "required records" are not clothed with constitutional immunity against self-incrimination. Although *Shapiro* did not involve records required to be retained by taxpayers as such, some post-*Shapiro* cases have implied that the principle of that decision should also govern taxpayers with respect to records required to be kept by them for tax purposes.[15] This rationale has been severely criticized.[16] At this writing, it seems unlikely that either the Department of Justice or the Treasury Department will fail to recognize the traditional right of the individual taxpayer to refuse to surrender his own books and records.

Records in custody of attorney

If the individual taxpayer retains possession of his books and records, as we have seen, he may refuse to surrender them to the investigating agents. But often it happens that they are out of his own possession, either temporarily or by reason of some fixed arrangement. The alert agent finds this out and serves a summons on the third party (usually taxpayer's attorney or accountant). What are this third person's rights and obligations? One can see that here is an important and sometimes crucial area of concern for the taxpayer.

Traditionally, there has been recognized a confidential relationship between an attorney and his client which extends to all communications between them. On this basis, the attorney may refuse to reveal any information regarding his client's affairs. The Treasury Department recognizes this right. However, there must exist a bona fide attorney-client relationship,[17] the role of the attorney must be more than that of a depositary of funds, scrivener of documents, an agent to make purchases for his client,[18] or of one who is rendering accounting rather than legal services.[19] The privilege of nondisclosure extends to all written documents (correspondence, client's papers, books and records) which remain in the lawyer's possession. The privilege extends to employees and agents of the attorney, such as a secretary, associates in his office, etc.[20]

In custody of accountant

It is equally well-established that as far as the Treasury Department is concerned, there is no privilege between an accountant and his client.[21] The Treasury Department refuses to recognize any such privilege even if state statutes specifically provide for it.[22] The unprivileged status of communications to

[5] United States v. White, 322 U.S. 694 (1944).
[6] Hale v. Henkel, 201 U.S. 43 (1906); United States v. American Stevedores, Inc., 16 F.R.D. 164 (D.C. N.Y. 1954). However, even this constitutional right of the corporation is personal and an officer in his individual behalf may not assert its rights. United States v. H. J. K. Theatre Corporation, 232 F.2d 502 (2nd Cir. 1956).
[7] Curcio v. United States, 353 U.S. —— (1957); United States v. Sclafani, 126 F. Supp. 654 (D.C. N.Y. 1954); Lapiparo v. United States, 216 F.2d 87 (8th Cir. 1954).
[8] In the Matter of Byron A. Cain, 239 F.2d 263 (7th Cir. 1956).
[9] Lapiparo v. United States, see note 7, *supra*.
[10] In Re Subpoena Duces Tecum, 81 F. Supp. 418 (D.C. Cal. 1948).
[11] *Ibid.*
[12] Note: *Constitutional Law and Evidence: Privilege Against Self-Incrimination: Partnership Records*, 44 CALIF. L. REV. 408 (1956).
[13] (a) Under Fourth Amendment: Boyd v. U. S., 116 U.S. 616 (1886). Cf. U. S. v. Kraus, (D.C. N.Y. 1921), where in an opinion by Judge Learned Hand in a case arising under the National Prohibition Act, it was held that the right given to revenue agents to inspect taxpayer's records did not give them the additional right either to seize the records or to make copies without the taxpayer's consent. (b) Under Fifth Amendment: Boyd v. U. S., see (a), *supra*. The claimed immunity, however, must be based on fear of prosecution for a Federal offense and not a state offense. U. S. v. Murdock, 284 U.S. 141 (1931). Cf. Feldman v. U. S., 322 U.S. 486 (1944).
[14] Shapiro v. United States, 335 U.S. 1 (1948).
[15] Falsone v. United States, 205 F.2d 734 (5th Cir. 1953); Beard v. United States, 222 F.2d 84 (4th Cir. 1955); *cert. den.*
[16] Kostelanetz and Bender, CRIMINAL ASPECTS OF TAX FRAUD CASES (1957), p. 45 *et seq.* Lipton. *Record Keeping and the Privilege Against Self-Incrimination*, N.Y.U. 14th Ann. Inst. on Fed. Taxation, p. 1331.
[17] VIII WIGMORE ON EVIDENCE (3rd Ed. 1940), Sec. 2292, *et seq.*
[18] Pollok v. U. S., 202 F.2d 281 (5th Cir. 1953); Banks v. U. S., 204 F.2d 666, 671; (8th Cir. 1953); McFee v. U. S., 206 F.2d 272, 276 (9th Cir. 1953).
[19] Olender v. U. S., 210 F.2d 795, 805 (9th Cir. 1954); Lipton, *Privileged Communications*, N.Y. U. 13th Ann. Inst. on Fed. Taxation, p. 955. Note: *Does attorney-client privilege extend to accountant hired by attorney?*, 2 JTAX 368, 1955; Louri and Cutler, *Lawyer's Engagement of Accountant In a Federal Tax Fraud Case*, 10 TAX L. REV. 227 (1955); Doyle, *What Is a Privileged Communication Where Lawyer Engages Accountant, etc.*, Marquette University Fourth Annual Institute on Taxation (Milwaukee) 254 (1954).

the taxpayer's accountant creates extremely important handicaps in dealing with the taxpayer's own books and records which may be in the accountant's possession when demand is made for them by an investigating agent. Further, the accountant's own files and work papers concerning the taxpayer's affairs are subject to seizure by legal process and may prove to be a lethal weapon against his client. The files may include net worth analyses, tentative amended tax returns, financial statements, communications from the taxpayer to the accountant which may constitute admissions by the taxpayer, to mention only a few.[23] In addition, damaging oral testimony may be extracted from the accountant either by the Special Agent on his summons or by the Grand Jury on its subpoena.

In this situation, some protective strategy may be employed. If an investigation is contemplated or is in progress and the accountant has not yet been contacted by the agents, all of the taxpayer's books, records and other material which may prove to be incriminating should be removed from the accountant's possession and returned either to the taxpayer or to his attorney. If the accountant—whether previously employed by the taxpayer, or called into the situation after the investigation has started—is to prepare defensive material of any kind, he should *ab inito* take the assignment only as the employee or agent of the attorney, to be paid by the attorney, and subject to the attorney's direction in all respects. This arrangement should be confirmed in writing. If the arrangement is bona fide, the privilege should then attach to the accountant's work papers and the Service is not likely to press for judicial enforcement of a demand that the accountant surrender these documents.[24]

It is not safe for the taxpayer to entrust his defense to one who is both an accountant and an attorney, for the reason that if this person undertakes to prepare defensive material which basically is of an accounting nature, the privilege likely will not attach.[25]

Other third parties

Since this taxpayer's privilege not to surrender his own books and records, lest they incriminate him, is personal to him and vests in no one else. it is clear that the taxpayer's books, records or other incriminating material, when found in the possession of other third parties, will be subject to commandeering by the investigating agents. This problem affects not only the accountant, as we have seen, but may affect the taxpayer's broker, banker, insurance agent, and others who may have occasion to have possession of all or some of the taxpayer's records, correspondence, etc.[26]

Waiving constitutional privilege

Often, a taxpayer waives his constitutional right to refuse access to his records by the simple process of voluntarily surrendering them to investigating agents. If this is done with full knowledge of his rights and as the result of a well-thought-out program, of course there is no basis for later complaint. However, a waiver of constitutional rights is just as effective on the part of a taxpayer who is not aware of his right to refuse access but who nevertheless surrenders his books voluntarily. The test is not knowledge of his rights but the voluntariness of the waiver. However, courts are slow to find that a waiver has taken place if there remains substantial doubt that in fact the waiver was voluntary and knowledgeable.

A special caveat: Although the constitutional right to refuse access is personal to the taxpayer and may not be asserted for him by another, sometimes a waiver of the taxpayer's constitutional rights may take place and affect him even though in fact the waiver is made by someone other than the taxpayer himself, as, for example, by his wife, by his employee, by his agent, etc.[27]

Must agent warn of rights?

In spite of some judicial eyebrow-lifting as to its equity in practice, it is nonetheless well-settled that in the absence of affirmative acts which reasonably could be construed as constituting misrepresentation, fraud, or coercion, there is no duty on the part of the Special Agent to warn the taxpayer that if he voluntarily surrenders his books and records for examination, they, or information derived from them, later may be used against him in a criminal tax evasion case.[28] However, there is considerable litigable controversy in this area.

If the Special Agent identifies himself and the taxpayer, without appreciating the significance of the situation, voluntarily gives the Special Agent (or the revenue agent acting jointly with him) access to his books, the taxpayer has irrevocably waived his privilege. There is no duty to warn and there is no duty to educate the taxpayer as to the potential danger of granting access.

If a revenue agent states that he is checking for possible additional civil tax liability only and the taxpayer, relying on this statement, makes his books available, and if in fact at that time the case has not been assigned to the Intelligence Division, and it later develops that on the basis of the revenue agent's preliminary investigation it would appear that fraud may be an issue, and the Intelligence Division has requested that a Special Agent be assigned for a joint investigation, and finally, if as a result of the subsequent joint investigation criminal charges develop, the taxpayer may not invalidate his waiver. Courts have recognized that what starts out to be a quest for taxes alone may well develop into a criminal case, and absent misrepresentation and fraud by the revenue agent at the time he requests the taxpayer's books, the waiver remains effective.[29]

But, if in the example above, at the time the revenue agent obtains a taxpayer's books either on the agent's express statement that he is seeking possible additional civil liability only, or even without such express statement, on the taxpayer's assumption to that effect, and if in fact the revenue agent is only "fronting" for a Special Agent to whom the case has already been assigned, there is a strong likelihood that a motion to suppress the use of a taxpayer's books and records in a criminal case may be granted after the indictment is brought.[30]

Disadvantages in refusing access

We now see that, generally speaking, the individual taxpayer has the constitutional right to refuse access to his records. This must be understood and appreciated. But whether, having this right, he should exercise it is quite an-

[20] VIII WIGMORE ON EVIDENCE (3rd Ed. 1940), Sec. 2301.
[21] Himmelfarb v. U. S., 175 F.2d 924 (9th Cir. 1949), *cert. den.*; Falsone v. United States, see note 15, *supra*.
[22] Ibid.
[23] This happened, for example, in Himmelfarb v. U. S., see note 21, *supra*.
[24] At least this is true as of the present writing.
[25] Olender v. U. S., see note 19, *supra*.
[26] For a more detailed study of this very important area, the following are suggested: Barker, *The Accountant in Fraud Cases: A Thorough Picture of This Fast-Changing Field*, 6 JTAX 20, 1957. (This article has an excellent bibliography on the subject); Balter, FRAUD UNDER FEDERAL TAX LAW (2nd Ed. 1953), p. 176 *et seq*; Balter, *Re-Evaluation of Tax Adviser's Role in Situations Where Fraud May Be An Issue*, U. of Denver 5th Ann. Tax Inst., (1954), p. 94; Balter, *The Accountant's Responsibility for Working Papers, Books and Records*, 32 TAXES 415 (1954); *Lipton, Record Keeping and the Privilege Against Self-Incrimination*, see note 16,

other problem. In fact, to the knowledgeable adviser this is probably the most crucial problem even if he is called into the case while there is still freedom of action. Here we do not intend to review the many-sided aspects of the basic arguments for and against "cooperation" with the investigating agents.[31] But enough must be discussed to frame the most important considerations which should be weighed in reaching the final decision on cooperation. Each course of action has definite risks. We shall attempt to point them out, as well as to indicate caveats corollary to following through on the course of action decided upon.

One of the principal disadvantages in refusing to turn over the taxpayer's records is that the suspicion of fraud will be strengthened in the agent's mind. "If you have done nothing wrong, you should have nothing to hide" is an old idea; the agent will have an increased suspicion that there must be some skeletons in the taxpayer's closet. He will be inclined to work harder to find them.

Upon denial of taxpayer's books, the agent will turn to indirect methods of proving deficiencies in tax. Since a deficiency in tax must be proved before a criminal evasion case or a civil fraud case will stand up,[32] the agent will resort to well-recognized indirect methods of proving undeclared income, such as net worth increase, bank deposits, cash expenditures, unit mark-up, etc.[33] His determinations, when approved by the Commissioner, will be presumptively correct, and since indirect methods of proof often are only approximations, the burden of proof, which is the taxpayer's, to show inaccuracies in the deficiencies set up by the agent, becomes difficult to bear.

The agent's report to his superiors will incorporate the taxpayer's failure to "cooperate." Even though the taxpayer has the legal right to refuse access, and even though he may be acting on the advice of counsel, the agent probably will lay stress in his report on the failure of the taxpayer to allow examination of books and records. At least at the administration level, this reference will carry some weight on the issue of fraudulent intent, especially in a close case.

The failure to cooperate may be an element in determining fraud in civil cases. It is well-settled that in a civil proceeding where fraud is the issue, the failure of a taxpayer to give the agents access to books and records may be considered an element indicating fraudulent intent in the filing of a false return;[34] and conversely, a taxpayer who gives the agents full access may win the fraud issue principally on this score.[35]

Finally, non-cooperation is properly relevant on the issue of "wilfulness" in criminal cases. Although subject to severe criticism as being unfair, the law is settled that a jury in a tax evasion trial may consider the failure of the taxpayer to turn over his books as bearing adversely on the issue of wilfulness.[36]

We have indicated the dangers in access to records. In spite of these disadvantages, access should be refused where the following conditions *concur*:

Whether or not the books are examined by the agents, where it is either reasonably certain that a criminal case will be recommended, or it is not reasonably certain that a criminal case will not be recommended, *and* it is unlikely that a criminal case can be successful without the taxpayer's books, directly or indirectly, supplying necessary evidence either as to the taxes due or as to the element of wilfulness (or it is not yet clear whether or not this situation in fact exists).

If a taxpayer decides to allow the agents to examine his books and records, he should be guided by certain rules of conduct, the principal of which may be listed as follows:

1. Do not tamper with, mutilate, or falsify any of the records.

2. Do not retain, conceal or destroy some records which agents know or would know must exist.

3. Be prepared to explain discrepancies between what the books show and what the agents will claim the true situation to be.[37]

4. Do not make false statements, oral or documentary, to the agents in an eagerness to "throw them off the track"; this may not only constitute a separate and additional crime, perhaps easier for the Government to prove than tax evasion itself,[38] but the statute of limitations for bringing tax evasion charges would start anew from the date of the false representation; the Government would not be limited by the period starting with the earlier date when the false tax return was filed.[39]

5. Expect demands for further "cooperation." If the taxpayer turns over his records, he is not through with the agents. Likely they will demand that he submit to a formal "question and answer" interrogation under oath; they may demand a net worth statement or other financial data corollary to the books and records. If the taxpayer refuses these additional steps evidencing "cooperation" to the agents, he may well lose the beneficial inferences he hoped to achieve by permitting access to his records.

6. Don't forget the rights retained after making records available. The taxpayer can inspect his records and make copies of them while they are still in the agent's possession,[40] and he can have them returned in a reasonable time.[41]

If you refuse access

If the decision is to refuse access, the principal guides for conduct are:

1. Be firm and consistent. Be careful not to offset the advantage of keeping

supra.

[31] Wiggins v. U. S., 64 F.2d 950 (9th Cir. 1933) *cert. den.*; U. S. v. Ashby, —— F.2d —— (5th Cir. 1957; Balter, FRAUD UUDER FEDERAL TAX LAW (2nd Ed. 1953), p. 168 *et seq.*

[32] Himmelfarb v. U. S., see note 21, *supra;* Hanson v. U. S., 186 F.2d 61 (8th Cir. 1950); U. S. v. Levy, 99 F.Supp. 529 (D.C. Conn. 1951; U. S. v. Burdick, 221 F.2d 932 (3rd Cir. 1955), *aff'd on remand, cert. den.*

[33] U. S. v. Frank, —— F.2d —— (3rd Cir. 1957); Turner v. U. S., 222 F.2d 926 (4th Cir. 1955), *cert. den.*

[34] United States v. Lipshitz, 132 F.Supp. 519 (1955); U. S. v. Wheeler (D.C. Pa. 1957); For further study in this involved field of constitutional rights and privileges, the following references not previously cited are suggested: Lipton, *op. cit. supra* at note 16. Lipton, *Safeguarding Constitutional Rights in Tax Fraud Investigations* 32 TAXES 263 (1954). Note: 57 COLUM. L. REV. 676, 1957.

[35] For basic discussion, see Balter, *Should Your Client "Cooperate" When Charged With Tax Fraud*, 29 TAXES 290 (1951); Balter, FRAUD UNDER FEDERAL TAX LAW (2nd Ed. 1953), Ch. VII; Platt, *Cooperation vs. Non-Cooperation in Tax Fraud Cases*, N. Y. U. 10th Ann. Inst. on Fed. Taxation, p. 1305; Goldring, *How to Claim Immunity in Tax Investigations*, TAX IDEAS, Par. 8023 *et seq;* Baradel, *How the Practitioner Should Prepare For a Fraud Examination*, N. Y. U. 12th Ann. Inst. on Fed. Taxation, pp. 57, 64; Boxleitner, *The Handling of Tax Fraud Cases*, Part 2, THE PRACTICAL LAWYER, p. 30 *et seq.* (May, 1956); Olsen, *The Revenue Agent Reacts to the Taxpayer and His Representative*, N. Y. U. 12th Ann. Inst. on Fed. Taxation, p. 1001; Balter, FRAUD UNDER FEDERAL TAX LAW (2nd Ed. 1953), Ch. VII.

[36] *Gleckman v. United States*, 80 F.2d 394 (8th Cir. 1935), *cert. den; United States v. Schenk*, 126 F.2d 702 (2nd Cir. 1942); *Summerill Tubing Co.*, 36 BTA 347 (1937); *Duffin v. Lucas*, 55 F.2d 780 (6th Cir. 1932, *cert. den.*

[37] For detailed discussion, see Balter, *op. cit. supra* at note 31, (2nd Ed. 1953), Ch. X, XIV; Balter, *Problems Relating to Taxpayer's Obligation to Retain Adequate Books and Records for Federal Income Tax Purposes*, 41 MARQUETTE L. REV. 107 (Fall, 1957).

[38] Powell v. Granquist (D.C. Ore. 1956); Wm. Lusk, 14 TCM 435 (1955).

[39] Thomas A. Talley, 20 TC 715 (1953); Hall v. U. S. (D.C. Ga. 1956).

[40] Smith v. United States, 236 F.2d 260 (8th Cir. 1956); Beard v. United States, see note 15, *supra;* United States v. Long (D.C. Pa.).

[41] United States v. Glascott, 216 F.2d 487 (7th Cir. 1954).

[42] United States v. Knisely, 200 F. 2d 559 (6th Cir. 1952), *cert. den.*; Knowles v. United States, 224 F.2d 168 (10th Cir. 1955).

[43] United States v. Beacon Brass Co., 344 U.S. 43 (1952).

[44] This may usually be arranged on reasonable terms.

[45] After the agents have photostated whatever records they desire to keep in their file and for subsequent court purposes.

[46] This problem has been discussed, *supra.*

[47] This problem has been discussed, *supra.*

the books from the agents by giving them some alternative means of achieving the same ends.

2. Immediately remove any of the taxpayer's books and records from the possession of those who cannot claim a privileged status and place them in the possession of the taxpayer or his attorney.[42]

3. Beware of waiver of rights. The taxpayer must be particularly cautious not to obey legal process served on him, whether it be a Commissioner's summons, a search warrant, or a Grand Jury subpoena, prior to court review and enforcement.[43]

Timing the decision

Since the decision as to access to records often is crucial to a taxpayer's case, it is of transcendent importance that the decision be knowledgeable and not the result of either ignorance or panic. Here are some practical guides:

1. Defer the decision at least until the basic facts are understood and can be properly evaluated as to the probable effect of the decision on foreseeable defenses.

2. Do not permit the agent's cajoling or threats to force the taxpayer into a premature decision to allow access to his records, and finally,

3. If after carefully studying the total situation, the taxpayer is still in doubt as to whether it is to his benefit to allow or to refuse access, then defer the decision for a while, because once access is allowed, the consequences are unavoidable. ☆

New fraud and negligence decisions

Net worth method improper; doctor's books are adequate. Through extensive and detailed evidence taxpayer, a doctor, convinced the court that his books and records were properly kept by his bookkeeper and office help and were a true record of his income. Substantially all of the records were available for inspection. Tests of their accuracy were made by direct correspondence with patients; by comparison with hospital and clinical records of patients; by a comparison of taxpayer's available time (after deducting that part of the work day spent in teaching and charity work at a hospital) with records of patients treated. Large cash transactions were shown to be loans from the taxpayer's father-in-law. Not only did the Commissioner fail to produce any documentary proof to sustain his assessed deficiencies, but his opening net worth figures were inaccurate, and failed to account for cash on hand, a stock certificate, and cost of automobiles purchased. Under such circumstances, the court concludes the net worth method was improperly used. *West,* DC Tenn., 9/9/57.

Commissioner must show likely source of income in net worth determination. This case was remanded by the Court of Appeals to the Tax Court to determine whether taxpayer had a likely source of income from which he could have derived the net worth increase on which the Tax Court determined deficiencies. The Tax Court interprets the remand to mean that in a net worth proceeding it is incumbent on the Commissioner to prove the likely source of taxable income by affirmative evidence independent of the fact that the taxpayer's net worth has increased. In the absence of such a showing, the taxpayer is not obliged to prove that the increases are from nontaxable sources. Here the Commissioner argued that taxpayer derived the increases from unreported income of his wholly owned dry cleaning corporation. The Tax Court finds the evidence does not prove the books erroneous. Since the Commissioner failed to meet his burden of proof, his asserted deficiencies and additions to tax are not sustained. *Thomas,* TCM 1957-244.

Net worth increase of IRS employee shows fraudulent omissions. A financial statement required to be submitted by an IRS employee indicated an increase in net worth over the period 1943-1951 of over $30,000 whereas his total reported gross income, less income taxes, for the same period approximated $32,600. The evidence showed that during the same period taxpayer received compensation for assisting others prepare returns. The compensation was in the form of hard-to-get tickets, and "gifts" to his children. The failure to report all of the income from these sources is considered by the court as deliberate and fraudulent. In addition, his claim of a dependency exemption for his father-in-law, which was entirely without foundation, is held to be a deliberate fraud in view of the fact that taxpayer as an IRS employee had a demonstrated knowledge of Federal income taxes. *McCarthy,* TCM 1957-194.

Net worth computation adjusted; fraud sustained. In adjusting the Commissioner's computation of taxpayer's income by the net worth method, the court allows an addition of $675 to the opening net worth representing the cost of improvements to property. A mortgage in the closing inventory is adjusted to 65% of its face value. Also, the payment of taxpayer's debt to a bank by his brother is held to result in a reduction of closing net worth regardless of whether the money was loaned or donated by the brother. Fraud penalties are sustained in view of taxpayer's substantial understatement of income, his failure to keep proper supporting data, and his failure to report interest income and gains from sales of real estate and mortgages. *Vitiello,* TCM 1957-214.

Net worth computation adjusted; fraud penalties not sustained. The court adjusts the Commissioner's net worth computations of two stockholders and a sales manager of a coin-operated machine business by allowing a greater amount for cash on hand at the beginning of the net worth period, and by reducing the estimated living expenses. It also finds that fraud could not be inferred from the taxpayers' refusal to talk to examining agents, and holds the fraud penalties were improperly imposed. *Westerhaus Co.,* TCM 1927-213.

Fraud conviction by net worth method sustained [*Certiorari denied*]. Taxpayer operated a pawnshop. Once a month a bookkeeper wrote up the books from memoranda supplied by the taxpayer. Most of the income and expenses of the business were in cash and revenue agents were unable to verify them. The Goveernment computed taxpayer's income by the net worth method. Defendant's nonbusiness expenditures over the four-year period involved in the indictment exceeded reported income by $280,000, which taxpayer explained by saying he had a large cash hoard, accumulated in prior years. Conviction for willful evasion was affirmed. *Epstein, cert. den.* 11/12/57.

Restaurant owner's income reconstructed by net worth. Use of the net worth

method against a restaurant owner is held clearly justified where no books or records were introduced in evidence to substantiate the income reported on his returns. The court determines the correct opening cash on hand as $5,500 in lieu of the $17,000 claimed by the taxpayer, and the $300 used by the Commissioner. Negligence and estimated tax penalties are upheld. *Cretecos,* TCM 1957-219.

Criminal conviction based on net worth upheld [*Certiorari denied*]. Taxpayer had been convicted of income tax evasion. The government's case had been based on net worth; taxpayer's records contained no information on cash sales except a note in a book said to be the monthly totals. Taxpayer explained net worth increases as due to a $80,000 cash hoard put in the business as needed. The Eighth Circuit upheld the jury verdict of guilty. The denial of a bill of particulars was well within the lower court's discretion. The government's opening net worth was established with reasonable certainty, nor did the government fail to investigate leads that might explain the net worth increase innocently. *Blackwell, cert den.* 10/14/57.

Opening net worth determined by Tax Court is approved. The Tax Court had determined deficiencies against taxpayer based on net worth computations. In a previous opinion this court approved the deficiencies in principle but remanded because the Tax Court had found an opening net worth of zero although taxpayer paid $5,000 toward the purchase of a home a few days after the opening net worth date. On remand, the Tax Court gave him credit for this $5,000 item. This court approves the latter determination as being in accordance with the remand. *Rubino,* CA-6, 10/23/57.

Opening net worth proved by prior income tax statement. Taxpayer, a bootlegger, kept no records. During an investigation of tax returns for earlier years, he made a sworn statement of his net worth as of the end of that period. The IRS used that net worth figure as the starting point here and the Tax Court upheld it. This court affirms. *Davis,* CA-4, 11/7/57.

Due process doesn't always require accountant in net worth case. Taxpayer had been convicted of evasion; on appeal she argues that due process had been denied her because no accountant had been assigned to assist counsel and the Government's case had been based on net worth. This court concludes the trial had been fair. It specifically notes that it does not decide whether an accountant is ever necessary to insure "effective" legal counsel. Here, however, taxpayer's counsel had long and responsible experience in the IRS and had studied accounting; moreover, the only fault she found with the net worth case was the opening cash balance and the court points out that it would be hard to see how an accountant could assist in that argument. The court notes that the only two cases in which this issue has been previously raised were decided on timing. In *O'Connor* (203 F.2d 301) the due process question was raised too late and in *Brodson* (241 F.2d 107) it was raised too early. *Summers,* CA-9, 12/5/57.

Reconstruction of business income from shipping memoranda not acceptable. Two brothers were partners in a seafood business for which no books and records were kept other than shipping memoranda. The Commissioner attempted to reconstruct the partnership income by building up partnership sales from the shipping memoranda, and by computing costs as 60% of sales. The court finds, on the basis of all the evidence available to the Commissioner, the method he used could not be sustained. It was not based upon the best evidence available, and the method was not one which clearly reflected the partnership income. *Willis,* TCM 1957-223.

Doctor's income reconstructed from patients' cards. The Commissioner's determination of a doctor's unreported income was based upon receipts from patients reflected upon the patients' cards, as shown in the audit of those cards by the doctor's own accountant. Later, the doctor claimed the Commissioner should have used the net worth method in making the determination, and that that method would produce a lesser amount of unreported income. The court, however, upholds the Commissioner, stating that although the net worth method is acceptable as a means of showing income where other more precise methods are unavailable, it is less accurate in the present case than the method used. Fraud penalties were sustained since the amounts omitted were too large and the practice of underreporting extended over too long a period to have been the products of mere error. *Funk,* 29 TC No. 32.

Income reconstructed from bank statements; lack of due process in IRS withholding of records not considered. In reconstructing taxpayer's income on the basis of bank deposits and withdrawals, the IRS agents in 1950 and 1951 took away taxpayer's bank statements, checks, and other data relating to his business. The material was not returned to taxpayer until the fall of 1954. Taxpayer argued in his brief that he was denied due process in that the agents prevented him access to his records so as to deny him the opportunity to prepare his case and meet the burden of proof imposed upon him by statute. However, the court refuses to consider the constitutional question since the issue was not raised in the pleading, and sustains the deficiencies upon taxpayer's failure to meet his burden of proof. Even though the return was signed by taxpayer's wife, the court finds that the wife's signature was obtained under duress, and holds her not liable for any deficiencies. *Frederick,* TCM 1957-225.

Customer's check admitted to prove unreported income, though drawn to cash. Taxpayer was found guilty of tax evasion; the Government's case charged him with not reporting income from sales. In affirming, the court holds it was proper to admit as evidence some checks drawn by his customers even though they were made out to cash and not endorsed by taxpayer. Notes on the stubs and entries in the purchasers' books tied them in as a link in the chain. *Bodnar,* CA-6, 10/18/57.

Bank deposit method rejected. Taxpayer had several income-producing activities for all of which he kept adequate records which were in accord with his tax return. He denied any other sources of income and none was seriously suggested. The court rejects the Commissioner's determination of deficiencies on the basis of unreported bank and brokerage deposits in the light of taxpayer's credible explanation of the accounts. *Saffan,* TCM 1957-184.

Court fails to find that "protection" payments were received by police. The Commissioner alleged that taxpayers, two police officers, fraudulently omitted from income "protection" payments re-

ceived from certain named individuals in carrying on places of gambling and prostitution. However, on the basis of evidence submitted, the court finds that the Commissioner has failed to carry his burden of proof as to fraud, and that the police officers have carried theirs in refuting the deficiency assessments. *Nelson,* TCM 1957-215.

Fraud penalties sustained for unreported income. Taxpayer was in the business of selling electrical appliances for export during 1947 in his own name, and as a member of a partnership. Neither taxpayer nor the partnership filed a return for that year. The court sustains the fraud penalty upon a finding that taxpayer deliberately avoided the payment of tax on net income of at least $6,000. *Harris,* TCM 1957-217.

Doctor's failure to report substantial amount of income was fraud. Deceased taxpayer, a doctor, omitted over $47,000 of income for the year 1947 (he reported about $24,000). The executor argued that the error was due not to intentional fraud but to negligence of employees in his office. This court affirms the Tax Court, which held that a doctor conducting an individual practice must have been aware of his income and that the gross understatement must have been apparent to him. *Haskins Estate (Harber Ex'r),* CA-6, 10/25/57.

Substantial understatement evidences fraud; penalty applies to voluntary payments [*Certiorari denied*]. The consistent understatement of substantial income by an experienced businessman over a period of years, coupled with his failure to offer any tenable explanations for the omissions, was held by the Tax Court to evidence a fraudulent intent to evade tax. No merit was found in taxpayer's argument that the 50% fraud penalty could not be applied to the entire deficiency where part was voluntarily paid prior to the deficiency notice. In affirming, the Fourth Circuit held that the entire amount paid prior to the deficiency notice should be credited to the tax itself, resulting in a small change in the interest charge. *Romm, cert. den.* 10/28/57.

Felony conviction for taxpayer who understated income and claimed nonexistent dependents [*Certiorari denied*]. Taxpayer failed to report income received as an employee of an income tax service. He also claimed exemptions for false dependents. The jury found him guilty of filing false returns. The Second Circuit held that conviction under the felony statute was proper. *Lennon, cert. den.* 10/14/57.

Fraud penalties imposed on roadhouse operator. Decedent owned and operated a night club near an army air base. He maintained no books or records, and gave contradictory and untrue explanations for the absence of books. The Commissioner reconstructed his income by use of the net worth method. Noting that decedent consistently failed to report large amounts of his income, that his manner of conducting business was not that of an honest taxpayer, and that with regard to one of the taxable years he was convicted for income tax evasion, the court finds that the Commissioner sustained his burden of proving fraud for each of the taxable years. *Ett Estate,* TCM 1957-206.

Police Chief's return fraudulent. The Tax Court's use of the net worth method in determining the income of a local chief of police is sustained; he failed to report interest income, real estate rentals, dividends, distributable shares from a poker club, and the true gains from real estate sales. The opening net worth found by the Tax Court was, if anything, generous. The record furnishes ample grounds for the finding of fraud. The statute of limitations on assessments was ruled inapplicable since fraud was proven. *Baumgardner,* CA-9, 12/21/57.

Delinquency penalty on CPA who consistently filed skeleton returns; didn't start statute. Taxpayer, a CPA, on the last day for filing returns for 1945, 1946, and 1947, filed skeleton Forms 1040 which did not show in detail the items of income he received during the year, the deductions claimed, or any expenses incurred. Although the forms contained amounts alleged to be the tax liability for the year, none of the forms contained any computation of tax. Moreover, for the years 1945 and 1946 no complete returns reflecting these details were ever filed, but for 1947 taxpayer later filed a more detailed return. The court holds taxpayer's failure to file timely returns which he attributed to the pressing demands of his accounting business was not due to reasonable cause but to willful neglect. Deficiencies and delinquency penalties are held not barred for 1945 and 1946 since no valid return was ever filed, but the assessment for 1947 is barred because mailed more than three years after filing the adequate return. *Bell,* TCM 1957-201.

Bill of particulars included income omission only; duplication of deduction admissible on intent [*Certiorari denied*]. The taxpayer did not report a $45,000 real estate commission on his personal income tax return, but it was reported by the taxpayer's corporation, which had a loss. The Fifth Circuit held there was no error by the district court in admitting evidence that substantial expenses were deducted twice, once by the taxpayer and again by his corporation. While this evidence could not be admitted in proof of evasion (the Government had in its bill of particulars alleged only the $45,000 omission), it was admissible to show intent to defraud. *Harris, cert den.* 10/14/57.

Lack of funds not reasonable cause for failure to make timely installment payment. A partner in a stock brokerage firm failed to make timely payments of estimated tax installments because of lack of funds due to business difficulties, in spite of the fact that he reported substantial net incomes for the years in issue. The failure is held not to constitute reasonable cause and the penalties upheld. *Heffernan,* TCM 1957-205.

Failing to file not fraudulent; taxpayer was illiterate [*Acquiescence*]. Taxpayer, an illiterate laborer, built crude shacks, and as an operator of a small grocery store and two taverns dealt in simple merchandise, wine, and beer. Considering the taxpayer's background, his environment, and his experience in business activities, the court holds that his failure to file returns for the years 1941-1950, although attributed to negligence, was not due to fraud with intent to evade tax. *Thurston,* 28 TC 350, *acq.* IRB 1957-45.

Lawyer's conviction for failing to file return upheld. Taxpayer, a lawyer who had prepared and filed tax returns for clients, was convicted of failure to file his own. The explanation that he did not know he was required to file the return if he lacked the cash to pay the tax is, the court says, so unreasonable as to justify the judge below in not accepting it. *Rippinger,* CA-4, 10/21/57.

TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

EDITED BY JOSEPH TRACHTMAN & J. A. MANNING

Warning on non-commercial annuities; a popular but hazardous tax-saving device

by **ROBERT E. NELSON**

An exchange of property for an income for life appeals to many taxpayers as a simple way to rearrange family property-holding as the owners gradually drop management into younger hands. Unfortunately, tax results of such exchanges are far from certain. Mr. Nelson, Green Bay, Wisconsin, attorney, analyses the contradictory position taken by the courts and the IRS and concludes with the caution that taxpayers interested in this device ought to be advised to use another method of achieving their ends, in this article based on a paper presented at the Eighth Annual Marquette University Institute on Taxation.

THE USE of noncommercial annuities in estate planning seems to vary in popularity from one locality to another. In some areas, for instance, the transfer of a farm by the father to the son in exchange for a promise of support is a far more popular device than even a will.

A number of universities and other tax-exempt organizations promote transfers of property to them in exchange for a promise of a lifetime annuity. In marital deduction trusts, provision is often made for the wife to receive more than the income from the property each year. This additional annuity eats up the wife's property so that at her death there are less death taxes in passing her property along to the children. In extreme cases the amount placed in the marital deduction trust may be based upon a computation of her annual needs and the amount necessary to fund them as an annuity.

As popular as the device may be, the amount of tax litigation on this subject has been small and the court decisions fail to present a coherent picture.

I. NO ELEMENT OF GIFT

Where the private annuity arrangement is used in estate planning, there is frequently some element of gift, because the amount transferred—usually from the older person to the younger person—is more valuable than the annuity promised by the younger person. However, because this element of gift complicates the situation considerably, let us first examine the tax consequences where no element of gift is present.

Purchase with cash

The simplest situation is a father's transfer of a sum of money to his son in exchange for the son's promise to pay him a fixed annual sum for the rest of his life. Under the 1954 Code, the tax consequences of this transaction are fairly certain.

There seems no reason to suppose that the rules under Section 72 which govern commercial annuities will not also be applied to private annuities. In fact Regulations 1-72-2 provide: ". . . for the purposes of Section 72 . . . it is immaterial whether such contracts are entered into with an insurance company."

These Regulations define an "annuity" as an arrangement where amounts are payable at regular intervals over a period of more than one year, provided the total amount payable or the total period can be determined from the beginning.

If, at a time when his life expectancy is 13⅓ years, a father pays his son $12,650 for the son's promise to pay him $100 a month for life, the exclusion ratio to be used by the father is $12,650/$16,000, or 79.1% ($16,000 is $1,200 a year for 13⅓ years). Thus out of each $100 payment, $79.10 is excluded from the father's income and the balance is ordinary income. This $79.10 is excludable from every payment, even though the father outlives his expectancy so that he recovers more than his investment of $12,650 tax-free.

Under the 1939 Code, 3% of the cost of $12,650 would have been taxed to the father until the untaxed portion of each payment equaled the cost of the contract $12,650. Thereafter all amounts received by the father would have been income.

Purchase with property

If the father transfers property to the son instead of cash, problems begin. Is there one transaction or two? Is there merely the sale of the property for an annuity, or is there a sale of the property at fair market value and a purchase of an annuity for that amount?

In *M. J. Ware*[1] taxpayer transferred improved real estate with a cost basis of $14,000 in exchange for a promise to pay $150 per month for the joint lives of the taxpayer and his wife. The Fifth Circuit held that this was merely an annuity contract and not a sale of the property for a definite sum, so that when the cost basis was recovered, all further payments were ordinary income rather than capital gain.

This decision does not appear to reflect the current position of the Commissioner or of other courts which have considered the problem, especially as to the annuitant's tax situation.

In *C. V. Hill Estate*,[2] a father transferred securities worth $360,000 to his son for a lifetime annuity of about $20,000 per year. The court treated this as a sale of the property for fair market value and a purchase of an annuity for the same amount. Thus 3% of the fair market value of the stock was taxable to the father as ordinary income. The remainder of each payment was return of the father's cost basis until that was recovered. Thereafter the portion of each payment in excess of 3% of the fair market value on the date of the transfer was capital gain, until the full capital gain had been recognized.

In *Revenue Ruling* 239,[3] the Government takes the same double view of the

[1] 159 F.2d 542 (5th Cir.).
[2] 58 F. Supp 164 (DC N. J.).
[3] 1953-2 CB 53.

transaction. The fair market value of the property transferred is taken as the cost of the annuity and also as the sale price of the property.

Gain or loss to annuitant

Assuming that the transfer of property in exchange for an annuity is a sale at fair market value and there is no element of gift, the annuitant still does not realize any capital gain in the year of sale, because the promise of a private person has no fair market value. Not until the annuitant has recovered tax-free his cost basis of the property does he have capital gain.

In *J. D. Lloyd*,[4] Harold Lloyd's father transferred stock to him in exchange for a promise of $100,000 per year for the taxpayer's life. Although the Commissioner proved that the annuity would cost about $850,000 if purchased from an insurance company, the board held that the father realized no gain in the year of the transfer because the promise of his son had no fair market value.[5]

Neither is any loss permitted in the year of sale—not only because the son's promise has no fair market value, but because the transaction is not one entered into for profit.[6]

Nor is any loss allowed to the annuitant in the year of his death because he failed to receive back his investment. In *Industrial Trust Co.*,[7] the annuitant paid $57,000 for an annuity policy and had received back only $32,000 when he died. The court took the view that this was a closed transaction and the fact that the annuitant died before his life expectancy gave rise to no loss.

Cost basis to purchaser

The cost basis to the purchaser of the property who promises an annuity in payment has been a very unsettled question for many years. In *Revenue Ruling* 55-119,[8] the Government finally outlined its position on the cost basis to the purchaser, but this has changed somewhat in the new, proposed Regulations on basis.

Accepting the double view of the transaction, *Revenue Ruling* 55-119 holds that immediately after the transfer the basis for depreciation is the present value of all annuity payments expected to be made. This rule is consistant with *Trottman*,[9] which concerned a mother who transferred a royalty contract to taxpayer in return for an annuity of $150 per month. The Tax Court held that taxpayer's basis was the *present value* of the expected payments to the mother —not the total annual payments multiplied by the mother's life expectancy. *Revenue Ruling* 55-119 suggests that the annuity tables in old Regulations 108, Section 86.19(f), should be used for this computation.

This emphasis on the present value of the annuity seems inconsistent with *Revenue Ruling* 239,[10] which takes the fair market value of the property as the cost of the annuity for the purpose of determining the amount taxable to the annuitant. A third possibility is the cost of a comparable contract from a commercial insurance company, and this is the value most often found in the court decisions.

Under *Revenue Ruling* 55-119, when the total payments actually made exceed the present value of the annuity, then the total payments become the cost basis. This stage would appear to result in awkward depreciation computations because the cost basis would increase each year, as additional payments above the present value are made. If the annuitant dies before payments totalling the present value have been made, the basis (unadjusted) for depreciation drops back to the actual payments made, also.

However, the rule is consistent with *Forrester*.[11] There a father transferred securities to the taxpayer, his son, for a promise to pay $500 a month for the joint lives of the father and mother. The value of a comparable insurance company contract was approximately $40,000, and taxpayer had paid out only $34,500 when the survivor died. The Tax Court held that taxpayer's basis was $34,500, not $40,000.

Along the same line, in *Citizens National Bank of Kirksville*,[12] the Eighth Circuit held that the purchaser was not entitled to any deduction when his payments began exceeding the cost of a comparable insurance company contract. Similarly in *Steinback Kresge Company*,[13] a father transferred stock in a family corporation to the corporation for its promise to pay him $73,000 per year for his life. The court held that the life expectancy of the father and the present value of the annuity were not material. No deduction could be allowed the corporation because the father exceeded his life expectancy.

Thus the double view is not followed completely. The present value is taken as the basis originally, but if the annuitant dies before the total expected payments are paid, the total is taken as the cost basis, and if more payments are made than expected, the total of those becomes the purchaser's basis. The holding in *J. C. Moore Corp.*[14] which permitted the purchaser an interest deduction each year for the difference between the amount of such payment and its present value on the date the annuity started is not approved.

Sale during annuitant's lifetime

If the farm is sold before the father's death, the basis for determining gain on the sale and the basis for determining loss are different, under *Revenue Ruling* 55-119. The basis for determining gain is the total payments made to the date of the sale (less depreciation), plus the commuted value of the remaining payments, based on the father's age *at the date of the sale*.

The basis for computing loss is merely the total actual payments made to the date of the sale (less depreciation). Note that there may be neither gain nor loss, if the selling price falls between the basis for gain and the basis for loss.

If the farm is sold by the son at a gain and if the father thereafter dies *before* all the expected annuity payments are made, the son realizes income in the year of death to the extent of the payments he will never have to make, because they were included in his basis for gain.

If the farm is sold at a gain by the son and the father lives longer than his expectancy, so that the son makes more payments than expected, the son has a deductible loss as each excess payment is made.

If the farm is sold at a loss, every subsequent payment is deductible by the son.

Where no gain or loss is recognized, because the selling price falls between the basis for loss and the basis for gain, the son's payments are deductible after the total paid exceeds the selling price.

Such gains and losses arising out of payments subsequent to the father's death are ordinary or capital depending on the purpose for which the son held the property, according to *Revenue Ruling* 55-119.

II. TRANSACTION PART GIFT

In the usual estate planning situation, the father will transfer property with a value in excess of the present value of the annuity promised. If so, the excess is obviously a gift.[15]

For the purpose of computing the exclusion ratio, only the present value of

such payments as computed under the tables in old Regulations 108, Section 86.19 (f) (or possibly the cost of a comparable annuity contract from an insurance company) should be used as the "investment in the contract." It can be seen that if the present value is computed from the tables, the exclusion ratio will always be the same.

Under the 1939 Code, in *P. A. Gillespie*,[16] taxpayer transferred property worth $732,000 to a corporation in return for a promise of $15,000 a year for life. The cost of a comparable annuity contract from an insurance company would have been $196,000. The court held that only 3% of $196,000 was taxable each year to the annuitant. Likewise, in *Anna L. Raymond*,[17] the cost of a comparable commercial contract was used as the cost of the annuity rather than the much higher fair market value of the property.

Gain or loss to the annuitant

There is no definite authority on how to compute the gain or loss to the annuitant if there is an element of gift in the transfer. *Revenue Ruling* 55-119 would have divided the property into two parts and treated the transaction as part sale and part gift. The cost basis would have been divided in the ratio that the fair market value of the annuity bears to the fair market value of the property transferred.

At the time this ruling was issued, those provisions appeared contrary to *Fincke*.[18] Now in the proposed Regulations on basis, Regulations 1.1001-1(e), there is again no splitting of such transactions into part gift and part sale. The following examples fully illustrate the proposed rules:

"Transfers in part a sale and in part a gift.—1. Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis. For determination of basis of the property in the hands of the transferee see §1.1015-4.

"2. *Examples.* The provisions of subparagraph (1) may be illustrated by the following examples:

"*Example A.* A transfers property to his son for $60,000. Such property in the hands of A has an adjusted basis of $30,000 (and a fair market value of $90,000). A's gain is $30,000, the excess of $60,000, the amount realized, over the adjusted basis, $30,000. He has made a gift of $30,000, the excess of $90,000, the fair market value, over the amount realized, $60,000.

"*Example B.* A transfers property to his son for $30,000. Such property in the hands of A has an adjusted basis of $60,000 (and a fair market value of $90,000). A has no gain or loss, and has made a gift of $60,000, the excess of $90,000, the fair market value, over the amount realized, $30,000.

"*Example C.* A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $30,000 (and a fair market value of $60,000). A has no gain and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

"*Example D.* A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $90,000 (and a fair market value of $60,000). A has sustained no loss, and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000."

Basis to purchaser

The proposed Regulations also cover the basis to the purchaser where a transaction is part gift and part sale. Regulations 1.1015-4 provide:

"Transfers in part a gift and in part a sale—(a) General rule. Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of (1) the amount paid by the transferee for the property, and (2) any excess of the transferor's adjusted basis over such amount. Thus, the unadjusted basis of the property in the hands of the transferee is the greater of (1) the amount paid for the property, or (2) the transferor's adjusted basis at the time of the transfer. For determining loss, the unadjusted basis of the property in the hands of the transferee shall not be greater than the fair market value of the property at the time of such transfer. For determination of gain or loss of the transferor see §1.1001-1(e).

"(b) *Examples.* The rule of paragraph (a) is illustrated by the following examples:

"*Example* 1. If A transfers property to his son for $30,000, and such property at the time of the transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $30,000.

"*Example* 2. If A transfers property to his son for $60,000, and such property at the time of transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

"*Example* 3. If A transfers property to his son for $30,000, and such property at the time of transfer has an adjusted basis in A's hands of $60,000 (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

"*Example* 4. If A transfers property to his son for $30,000 and such property at the time of transfer has an adjusted basis of $90,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $90,000. However, since the adjusted basis of the property in A's hands at the time of the transfer was greater than the fair market value at that time, for the purpose of determining any loss on a later sale or other disposition of the property by the son its unadjusted basis in his hands is $60,000."

Example (3) above corresponds with the holding of the Board of Tax Appeals in *May Rogers*.[19]

No fixed payment

Too often in these private annuity arrangements there is no fixed annual payment. The son merely promises to

[4] 33 BTA 903, (*acq.*).
[5] Similarly *Frank C. Deering*, 40 BTA 984 (*acq.*); *B. F. Kann Estate*, 174 F.2d 358 (3rd Cir.); *Hommel*, 7 TC 992 (1946), (*acq.*).
[6] *Evans v. Rothensies*, 114 F.2d 958 (3rd Cir.). To the contrary, *Donald H. Sheridan*, 18 TC 381 (1952), (*acq.*).
[7] 94 F.2d 927 (3rd Cir.), *cert. den.* 304 U.S. 572.
[8] 1955-1 CB 352.
[9] 3 TCM 316 (1944).
[10] *Supra* note 3.
[11] 4 TC 907, (1945).
[12] 122 F.2d 1011 (8th Cir.), *cert. den.* 315 U.S. 822.
[13] 33 F. Supp. 987, (DC N. J.).
[14] 42 F.2d 186, (2nd Cir. 1930).
[15] *Koert Bartman Estate*, 10 TC 1073 (1948).
[16] 128 F.2d 140 (9th Cir.).
[17] 114 F.2d 140 (7th Cir.), *cert. den.* 311 U.S. 710. However, the cost of a comparable commercial annuity contract is not always accepted as the cost. In *Bettie*, 159 F.2d 788 (6th Cir.), taxpayer transferred property to a college in exchange for an annuity. The Sixth Circuit held that she must report 3% of the fair market value — not 3% of the cost of a comparable commercial contract.
[18] 39 BTA 510 (1939). Originally the Commissioner non-acquiesced in this decision. In 1939-2 CB 12, however, the non-acquiescence was withdrawn and acquiescence noted. At the same time IT 2681, XII-I CB 93 (1933), which required a split basis, was revoked.
[19] 31 BTA 994 (1935).
[20] 28 F.2d 748 (8th Cir. 1928).
[21] 54-1 TC 10,937 (DC Ore.).
[22] 88 F.2d 807, (8th Cir.), *cert. den.* 301 U.S. 708.
[23] *Mason Trust*, 136 F.2d 335, (6th Cir.).

support his parents in reasonable comfort, or even if a fixed monthly sum is provided, he is also obligated to pay funeral and medical expenses and perhaps furnish the use of a car.

Nevertheless, it appears that such arrangements will still be treated as annuities under Section 72 of the 1954 Code. The Regulations under that Section provide that amounts are still considered annuities although they may vary with a price index or with the profits from a particular business. The approach is to use the estimated payment each year as the annuity and to treat any excess payment received each year as ordinary income. Presumably the son would be given an ordinary deduction for any such excess payments, although there is no authority for this. In *Mastin*,[20] a mother and an aunt transferred property to a son and nephew on the condition that he would pay their living expenses for the rest of their lives. The court held that the payments were not deductible but were capital expenditures made to acquire the property.

In none of these situations, of course, do the sums paid to the father entitle the son to a dependency credit. The annuity payments are in reality installment payments on the purchase price of the farm —not support payments.

Estate tax consequences

The gift tax implications where the property is worth more than the annuity are obvious. The Federal estate tax consequences are in more doubt.

In *U. S. Nat'l Bank of Portland, Oregon*, [21] the decedent in 1937 transferred securities to her daughter in exchange for an annuity of $5,000 per year for the decedent and her husband. Although the Government claimed that the reservation of the annuity made the transfer one taking effect at death, the court held that none of the property was includible in the decedent's gross estate. Apparently the value of the property was not disproportionate to the value of the annuity.

On the other hand, in *Updike*,[22] where the decedent transferred substantially all his property to his sons in return for a fixed annuity, the Eighth Circuit indicated strongly in its opinion that the entire value of the property could have been included in his gross estate less only the excess of the value of the annuity over the value of the income from the property, although the Commissioner did not make that contention.

The court emphasized that the annuity promised was less than the expected income from the property: ". . . why should the tax be less where he has transferred in contemplation of death and the transferee in substance has agreed to collect the income and pay it back to him in the form of an annuity? The transferees lost nothing in the lifetime of the decedent . . . To regard such an annuity as consideration would lead to absurd consequences. To evade estate taxes, if that were the rule, all the owner of property need do would be to transfer his entire estate in contemplation of death and require the transferee to pay back the income as an annuity."

Thus it appears that where the value of the property is so greatly in excess of the value of the annuity that the annual annuity reserved is close to the income from the property, the transaction may be held a transfer taking effect at death. Of course, this can be avoided by transferring only enough property to match the annuity and making a separate gift of the excess.

Bequests of annuities

If an annuity is given to a beneficiary under a will, the annuity rules of Section 72 do not apply at all. The annuity bequest is considered to be merely a distribution provision and the beneficiary will realize income with every payment to the extent that the trust from which it is paid has income for the year, under all the rules of the Code relating to the taxation of estates and trusts. This is true even though the payment is to be made from corpus only.[23]

Conclusion

There is no doubt that the noncommercial annuity could be a very useful device in estate planning under the proper circumstances. However, the tax consequences are so complicated and uncertain that it is difficult to use as frequently as desired. Section 1241 of the House Bill of the 1954 Code contained elaborate provisions covering the exchange of property for an annuity contract. However, Congressional Committee members studying these provisions apparently found that they raised as many problems as they solved, and this Section was dropped completely from the final draft.

In many cases, an ordinary installment sale from the father to the son will present a lower tax cost to the father and more definite tax consequences for everyone. For instance, the depreciable assets on a farm may be sold to the son for installment payments over a period which about equals the father's life expectancy. The undepreciable assets, (the land and dwelling house) may be given outright to the son. Thus, the son has the highest possible basis for depreciation and the tax cost to the father will usually be below what it would be if an annuity were promised.

Until additional legislation, court decisions, and rulings clarify the tax treatment of the noncommercial annuity, the device must be used with proper awareness of the problems involved. ☆

Custodian seeking to avoid estate tax hazard meets accounting difficulties

APPARENTLY the Treasury's recent *Revenue Ruling* 57-366 came as a surprise to many people. The *Massachusetts Law Quarterly* recently reported (in a memorandum by one of the Uniform Law Commissioners) that representatives of the New York Stock Exchange are trying to persuade the IRS to reverse its position. And we have recently run across a case in which a New York judge required a formal accounting (complete with guardian ad litem), where a change of trustee was petitioned for by reason of the new ruling.

The memorandum by Walter P. Malcolm, one of the Uniform Law Commissioners, pointed out that "in a recent ruling the Service has held that the value of property transferred by a donor to himself as custodian for a minor donee pursuant to the provisions of the Uniform Gifts to Minors Act adopted by a number of states is includible in the donor's gross estate for Federal estate tax purposes in the event of his death while acting as custodian and before the donee attains the age of 21 years (*Rev. Rul.* 57-366, IRB 1957-32). The Service analogized this situation to that of a donor transferring property to himself as trustee and retaining the right as trustee to pay the income and the principal

to a designated beneficiary or to withhold enjoyment of the property from the beneficiary until the beneficiary attains a certain age. In the latter case decisions of the Supreme Court have held that the value of the trust property is includible in the decedent-trustee's gross estate under Section 2038(a)(1) of the 1954 Code (*Harry Holmes,* 326 U.S. 480 and *Louis Lober,* 346 U.S. 335).

In view of previous discussions by persons interested in the enactment of the Uniform Gifts to Minors Act in various states, this recent ruling came as a surprise to representatives of the New York Stock Exchange. It is understood, Mr. Malcolm concludes, that they will request that the IRS reconsider the ruling and reverse its opinion expressed therein.

The resigning custodian

A father who made gifts under New York's gifts to minors act and had made himself custodian sought to resign and appoint his wife to be custodian. The decision of Mr. Justice Saypol of the New York Supreme Court (*Straus*), reported in the *New York Law Journal* 11/13/57, stated that the father's purpose in wishing to resign was simply to avoid the possibility of an estate tax if he should die before the donee became 21.

"The petitioner," the opinion stated, "makes application for an order, *ex parte,* granting leave to him to resign as custodian for his minor children and appointing his wife as successor custodian. Starting in 1956, pursuant to Article 8-A, Personal Property Law, he made gifts of securities to his children which he caused to be registered in his name as custodian. The reason for the change of trustees is a United States Treasury ruling (*Rev. Rul.* 57-366, IRB 1957-32) making the corpus taxable to the donor's estate upon his death before the minors' majority."

Turing to the legislative history of New York's gift to minors act, the court concludes that the relationship is one of trust. "Article 8-A . . . Personal Property Law, was added by Laws of 1956 . . . The object was to facilitate gifts of securities to minors by transferring them to a custodian for the minor. While section 266 . . . provides that such a custodian holds a power in trust, the whole statutory innovation suggests a departure from the recognized strict standards for trustees and trust administration. Ironically or otherwise, the supporting opinion of the State Banking Department in its legislative memorandum states, 'The custodian is to have almost all of the rights of an owner, except that he must act as a prudent man . . .'

"The proposal previously came before the Legislature in 1955. That bill was disapproved by the Committee on State Legislation of the Association of the Bar of the City of New York . . . , primarily because of the creation of a new fiduciary relationship and the elimination of established fiduciary responsibilities. The following year, when the law was enacted, the committee reversed itself, saying that its prior action of disapproval was taken despite its approval of the general purpose, but that it now approved mainly because of the newly added provision which establishes the relationship as a power in trust. In addition to the rights, powers and duties provided for in the bill, 'he shall have all the rights, powers and duties of a guardian of the property of an infant . . . . ' "

Since the custodianship is to be treated as a trust, the court continues to the logical corollary that the resignation can be accomplished only by the use of the same formal means required of a resigning trustee:

"The denomination of the office of custodian as a personal trust with the duties of a guardian of the property of an infant . . . requires legal representation of the infant . . . in an accounting proceeding . . . following the procedure dictated by article 79, Civil Practice Act. Let an order to show cause with provision for designation of a person to represent the infants be submitted." ☆

Appleman's new estate planning guide has 20 authors

BOBBS-MERRILL is bringing out this month a new two-volume set "Basic Estate Planning,"* edited by John Alan Appleman. It's a pretty substantial collection of material, from the pens of 20 practitioner-authors.

This is a very broad coverage of the subject. It fits in with what we think is the normal way to attack so big a collection of technical problems.

When we have a new problem, we like to look at it broadly, lay out a tentative solution, look around to see what the experts have to say about it, and what solutions they recommend, and finally get down to the minutiae of Code Sections and cases.

When the problem touches as many areas of special learning as estate planning, the tax man who has not specialized in this field (or, indeed, in one of its many subdivisions) is particularly in need of practical, sensible, broadly conceived, how-to-do-it advice that only the man of long experience can give. This kind of material has been published, but usually as short articles at law school tax institutes, bar meetings or meetings of other professional groups.

This new book provides just this kind of guidance in the entire field of estate planning. This is not a line-by-line commentary on the Code, with exhaustive analysis of the cases. Far from it. It is a clearly written, easy-to-read discussion of how to arrange the financial affairs of typical estate owners (chapters on the executive, the employee, the stockholder), with typical properties (chapters on the close corporation, the sole proprietor, trusts, the partner, life insurance), with typical problems (chapters on community property, marriage, divorce, gifts).

Only in the second volume do we get into the narrower problems of planning the after-death estate (chapters on trusts, preparation of the will, marital deduction, powers of appointment, estate procedure, income taxation of estates and beneficiaries).

Each chapter has a different author (or authors, and perhaps an assistant). The biographical sketches show they are all men of wide experience; most of the names will be familiar to readers of tax and legal journals. Obviously the general editor (Mr. Appleman) assigned the topics so as to insure coverage of the entire field and was able to obtain a remarkable uniformity in technical level and practicality of approach.

Probably one of the most valuable features of the book is the voluminous citations to papers at the various tax institutes. Many of the references to older papers add a comment on their current applicability. In addition, there are references to papers which are less likely to come to the tax man's attention—at bankers' and insurance men's meetings, regional bar meetings, etc.

And finally, this book will escape the unavoidable weakness of even the best tax institute paper—getting out of date. The publisher presents it in two normal size (about 500 pages each) volumes,

*Basic Estate Planning, by John Alan Appleman, The Bobbs-Merrill Co., Inc., Indianapolis, Ind., two volumes, 976 pages, $37.00.

with provisions for pocket parts, though he doesn't tell by whom the pocket parts will be prepared or the basis on which they will be issued. ☆

New estate & gift decisions this month

Remedial legislation broadly construed; marital deduction allowed. Decedent died on February 9, 1948, bequeathing the resident of his estate in trust to his wife for life, remainder to his two daughters. Should the annual income be insufficient to enable his widow to "live comfortably," and to provide for medical expenses, invasion of trust principal was authorized upon proper application to the probate court. Section 210 of the Technical Changes Act of 1953 permits a marital deduction where the decedent died between December 31, 1947 and April 2, 1948, the date of passage of the 1948 Revenue Act, provided that the surviving spouse is entitled to the income from the bequest for life and possesses a power to consume such portion of the property as she "may need or desire for her comfortable support and maintenance." The court holds that the present disposition comes within the broad application of the remedial legislation. The fact that the decedent directed that a certain clinic be retained among trust assets so long as it could be operated profitably did not place such portion of the trust property beyond the widow's reach, as her power of invasion included the clinic property. *Attix Estate,* DC Mont., 10/24/57.

Election deprives widow of tax-free share of estate; marital deduction reduced. [*Certiorari denied*]. Decedent's will directed that all estate and inheritance taxes assessed against his estate or its beneficiaries be paid from a residuary trust fund. His widow renounced her interest under the will and elected, under Indiana law, to take her intestate share. Nonetheless she attempted to reserve her right under the will to have the taxes on such share paid out of the residue. In a construction proceeding, the Indiana Probate Court directed that taxes attributable to her share be paid out of the residuary estate. The Commissioner nonetheless reduced the marital deduction by the amount of such taxes. The Seventh Circuit agreed with the Commissioner. Under the law of Indiana, the widow could not renounce the dispositive provisions of the will while at the same time retaining the benefit of its tax provisions. The decree of the Indiana Probate Court was the result of a nonadversary, undefended proceeding, and could not control in the present action. *Street Estate (Merchants Nat'l Bank, Ex'r), cert. den.* 11/25/57.
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Informal election given effect. In the same case which held that a decedent's estate was entitled to the modified marital deduction provided by the Technical Changes Act of 1953 for estates of decedents dying during the three-month period immediately prior to the passage of the Revenue Act of 1948, the Commissioner contended that the election required in such cases had not been properly filed. Instead of being signed by the surviving spouse individually, the election, which had taken the form of a claim for refund, had been signed by her in her capacity as executrix. The court holds it valid, however; the Commissioner had not been misled or deceived by this technical slip. Furthermore, the court notes that she as an individual would be estopped from contesting the validity of this election as executrix and her estate would be bound by her election; it is only equitable to bind the Government. *Attix Estate,* DC Mont., 10/24/57.

Gift for life, with power to consume, creates a debt, not a trust; accretion to corpus included in gross estate. Decedent bequeathed to his wife a life estate in certain stock with an unrestricted power to consume; the remainder, if any, going on her death to their children. The stock appreciated in value during her lifetime. The Treasury argued that the increase in value belonged to the decedent and went to her children as part of her estate and should be included in the taxable estate. The court agrees. Under her husband's will as governed by Pennsylvania law, she was not a trustee; she was a debtor owing to the children the value of the stock when she received it. The increment in value was hers and is includible in her taxable estate. *Soars Estate,* DC Pa., 11/8/57.

No gift tax on pre-divorce trust. Section 2516 of the 1954 Code provides that transfers of property from one spouse to the other under a written agreement followed by divorce within two years are not taxable gifts. Taxpayer here irrevocably transferred property to a trust, the income from which was to be paid to his wife to discharge marital and property rights. Upon the wife's death or remarriage, the trust property was to be distributed to a charitable foundation created by the taxpayer. A divorce followed shortly thereafter. The IRS rules that, pursuant to Section 2516, the transfer to the wife is not a taxable gift. The transfer of the remainder interest to the foundation is a gift, for which a charitable deduction is available. *Rev. Rul.* 57-506.

Beneficiary's amendment did not make him grantor of trust. The Commissioner included in the decedent's estate his interest in a trust created by his father, on the ground that decedent's exercise of a power of amendment amounted to the creation of a new trust in which he retained a life estate. Of course a grantor's estate includes a transfer with a retained life interest, but the court finds that decedent had not created a new trust. The trust as created by decedent's father gave decedent the income for life, with a testamentary power of appointment over the principal. Decedent also possessed the power to alter and modify the trust, provided he obtained the consent of the trustee. Decedent attempted to revoke and in settlement of litigation, by exercise of his power, took one-half the corpus of the trust outright, while the remaining one-half remained in trust, with himself as life beneficiary and his children as remaindermen. The court holds that decedent did not create a new trust of the remaining part of corpus, and consequently the trust assets are not includible in his gross estate as a transfer with a retained life interest. *Denzer Estate,* 29 TC No. 28, 11/15/57.

Trust instrument, not collateral agreement, given effect; trust corpus included in gross estate. Decedent and his wife entered a marital separation agreement which provided that the decedent create a trust, the payments under which were to be in full discharge of his wife's right to support, and which was as well to contain other dispositive provisions in favor of his children. The precise form of the trust was left to their respective counsel; nothing was said as to the trust being revocable or irrevocable. In the trust instrument itself, executed some

time later, a power of revocation, to be exercised jointly with others, was retained by the decedent-settlor. The retention of this power results in the inclusion of the value of the trust property in the estate of the decedent. The taxpayer's contention that the power of revocation was void from inception is without merit. The silence of the separation agreement on this point did not require that the trust agreement executed thereafter be irrevocable, and consequently did not violate the rights of the third-party beneficiaries of the separation agreement. Moreover, the decedent had four times exercised his power of modification during his lifetime. To find the power void, now that its usefulness is ended, or subject to collateral understandings or private arrangements, would frustrate the operation of the federal estate tax. *Joseph Estate (Kurz, Ex'r),* D.C.N.Y., 10/25/57.

Division of assets not a distribution for alternate valuation purposes. A revocable trust, the corpus of which was, pursuant to its terms, divided into separate parts for separate income beneficiaries subsequent to the death of the grantor, was included in the grantor's gross estate. This segregation, the IRS rules, does not amount to a distribution of property within the meaning of Section 2032, providing for an alternate valuation method of assets as of one year after death or date of distribution if divided prior thereto. The corpus of the trust does not cease to form a part of the decedent's gross estate by reason of a division of assets which merely facilitates the payment of income to the life beneficiaries. *Rev. Rul.* 57-495.

Life insurance proceeds includible under premium payment test (Old Law). The decedent in 1915 purchased two 20-payment insurance policies on his life. In 1939, after the policies had been fully paid, he created a revocable trust of the proceeds of the policies, reserving to himself all incidents of ownership. In 1947, he divested himself of all incidents of ownership. He died in 1951. By reason of his payment of the premiums, the insurance proceeds are includible in his gross estate. His retention of the incidents of ownership subsequent to January 10, 1941, prevents application of the relief afforded by Section 404(c) of the 1942 Revenue Act, which made the payment of premiums test inapplicable to paid-up policies transferred prior to that date. [Under the 1954 Code, a policy is not includible merely because the decedent paid the premiums.—*Ed.*] *Weil Estate* TC 1957-203.

Relief for transfers at death doesn't help one with retained life interest also. Decedent purchased two single premium annuity contracts under which she was to receive an annuity during her lifetime and, upon her death, her daughter was to receive an annuity for her life. The value of each policy is, the court holds, includible in the decedent's gross estate as a transfer with a retained life interest. The fact that the transfers might also be considered as intended to take effect in enjoyment after decedent's death, and, under such classification, would be free of tax because of the relief provisions of the Technical Changes Act of 1949, does not affect their includibility as transfers with a reversed life estate. *Arms Estate (Forster, Ex'r),* CA-7, 11/4/57.

Annuity valued on wife's actual physical condition [*Acquiescence*]. In valuing annuities which passed from decedent to his wife, the wife's actual life expectancy based on medical prognosis was considered; she had incurable cancer and died about a year after decedent. *Hoelzel Estate,* 28 TC 334, *acq.* IRB 1957-45.

Prior will discovered after return filed; statute runs from discovery. An estate tax was paid on the basis of the provisions of what was believed to be the last will of decedent. A later will, whose validity was established by litigation, contained a charitable bequest, which would have resulted in a lower tax, and prompts this claim for refund. The three-year statute of limitations does not, the court holds, bar the claim, as the executors filed it as soon as was practicable after the termination of the litigation which established the subsequent will's validity, and, prior to such termination, no claim for refund would have been possible. The statute of limitations, on the facts here, began to run from the time the right to claim an erroneous assessment was determined, not from the time of the remittance of the tax. In addition, the Government argued that if the claim was timely, this suit was not, having been brought prior to rejection or the expiration of six months after filing. The court notes that the taxpayer alleged the claim had been rejected by the District Director. If this action was unauthorized, it is incumbent on the Government to show he exceeded his authority. Lacking such proof, the court holds the suit timely. *Woods Estate (Walkden, Ex'r),* DC Ohio, 5/20/57.

State death taxes fully deductible, although final determination of amount due not yet made. Under Ohio law, the inheritance tax depends on the relationship of the final recipients to the decedent; when ultimate beneficiaries are not known, the estate is required to pay the highest possible tax and may obtain refund if nearer relatives actually succeed. The Commissioner argued that no deduction was allowable because of the possibility that, upon final determination of state inheritance taxes due, the sum paid by the executor might prove excessive, and a refund be payable to the estate. The court adheres to its previously expressed opinion that this state tax is no mere deposit but fully deductible. The Code provides special exception to the statute of limitations to permit assessment of Federal tax should the state tax be refunded. *Weisberger Estate (Thomas, Ex'r),* 29 TC No. 26.

Restrictive stock agreement not a gift. The stockholders of a family corporation entered into a restrictive stock agreement in order to ensure retention of family control. By the terms of the agreement, each stockholder reserved to himself a life interest in his own stock, with the remainder interests going to his children or, failing issue, to the other parties to the agreement. Each reserved the right to receive dividends and capital distributions. The court concludes that they made no completed gift. They could strip the remainder interest of all value by causing the corporation to distribute all its assets to them. The retention of this power, the Tax Court finds, resulted in a transfer lacking that degree of finality necessary for gift tax purposes. Although all of the parties had to act in concert in its exercise, they were not, under the circumstances, substantially adverse to each other. *Merritt,* 29 TC No. 20.

Notes on new estate and gift decisions in this department are by Edward P. Hannigan, member of the New Jersey Bar and associated with Harrison F. Durand in Newark.

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH P. STAPCHINSKAS

Storm blows up on Madison Avenue over new local taxes on advertising

THE ADVERTISING trade journals have been full of articles recently about the furious political battle in Baltimore between the city administration and the local papers which culminated in a city tax on advertising. Interest became more than local when other cities were reported to be interested in the revenue possibilities of this kind of tax. We asked John Dwight Sullivan, of Murphy, Block, Sullivan & Sawyer, New York, who is general counsel for the Advertising Federation of America, to explain for us the precise terms of the Baltimore tax and the legal, as opposed to the political, grounds on which it is meeting opposition. Here is how he summarized the controversy:

"The Baltimore City Council by a divided vote adopted two ordinances on November 15, 1957, imposing two taxes on advertising. The first imposes a tax on the sale of space for advertising purposes in any newspaper, magazine, periodical, program or directory published in the City of Baltimore, or on any billboard in the city or upon "any vehicle or airborne device which is principally operated in the City of Baltimore" or on any intrastate radio or television broadcast. The tax is to be collected from the advertisers themselves.

"The second ordinance imposes a 2% levy on publishers and broadcasters, the tax to be collected from them.

"Fourteen suits have presently been filed in the circuit court in Baltimore against the Mayor and City Council asking a declaratory decree that the ordinances be declared unconstitutional and praying for temporary and permanent injunctions against the enforcement of the ordinances, which became applicable on January 1, 1958. It is expected that these suits will come on for a hearing on or about March 1st.

"The suits contain substantially similar allegations, alleging that the tax violates freedom of speech and of the press, is discriminatory and is a direct burden on interstate commerce and is levied by ordinances too vague and ambiguous for enforcement.

"The ordinances were introduced in the City Council at the request of the city administration. At a public hearing held on November 13, 1957, they were vigorously opposed by representatives of newspapers, periodicals and television and radio stations. A representative of organized labor urged that there be an increase in the real estate tax if that became necessary to raise revenue, rather than by a tax on advertising.

"Throughout five hours of discussion not a single person who spoke either in opposition to the bills or in favor of them made any reference to the specific terms of the bills themselves. When representatives of publications contended that the bills were unconstitutional and would be struck down by the courts, the representative of the city solicitor expressed his own doubt as to whether the bills were constitutional.

"The bills themselves indicate that the draftsman had some considerable doubts on the question of constitutionality. The 4% bill contains a provision that if any taxpayer "erroneously or unconstitutionally" pays the tax, he may obtain a refund. The 2% bill contains a similar provision.

"It was made entirely clear during the public hearing on November 13, 1957, that there was open hostility between the city administration and the Baltimore Sunpapers and other publications, but despite the pleas and arguments made, the only concession to the opponents was the reduction of the proposed levy on the advertisers themselves from 7½% to 4%.

It is too early to judge the effect of the initial impact of the taxes. If an out-of-town and out-of-state advertiser refuses to pay the 4% tax, the Baltimore publishers will be responsible for the payment of it initially but may under the terms of the bill recover the amounts paid after the accounts have been charged off as worthless by the vendor during the taxable year.

"In the case of aviation advertising by way of skywriters or trail streamers, if the operator changes his place of operations from Baltimore to Wilmington, Delaware (20 minutes away by air). and continues his operation in the usual way, flying on airways which are under control of the Federal Government, there is nothing whatever the City of Baltimore can do about it.

"The Baltimore taxes are to be distinguished from the taxes which were upheld in other cases. In the case of *The New Yorker Magazine* v. *Geosa*, decided by the New York Court of Appeals in July, 1957, the New York court upheld the New York City tax on gross advertising receipts of the magazine and said: 'Neither the State Enabling Act nor the city local law expressly taxes advertising receipts.' The Baltimore tax is expressly levied upon advertising. The New York court quoted from *Western Live Stock*, 303 U. S. 50, which held in part: 'We think the burden on the interstate business is too remote and too attenuated to call for a rigidly logical application of the doctrine that gross receipts from interstate commerce may not be made the measure of a tax.'

"In the oft-quoted case of *Grosjen* v. *American Press Company*, the Supreme Court struck down the Louisiana statute (enacted during the regime of Huey Long) which would have imposed a tax on all papers having a circulation of more than 20,000 in the State of Louisiana. At the time, there were only two newspapers having a circulation in excess of 20,000." ☆

What's wrong with local property assessing today?

WIDESPREAD weakness in local assessments and local assessing practices have been found by the New York State Board of Equalization and Assessment. Studies in recent years show, says Frank C. Moore, chairman of the Board, the following principal weaknesses:

In many tax units there is wide varia-

tion in the levels at which the different types or classes of property are assessed in the same city, town or village. For example, farm property is generally assessed at a higher level than the average for the town, despite the fact that more than half of our town assessors give their occupation as farmers.

In addition, there is considerable variation in the level of assessment among parcels in the same class of property in the same city, town or village.

These variations exist in the assessment of similar property types in the same neighborhood, and sometimes among parcels on the same street or highway, or even adjacent to each other.

In addition, it has been noted that assessments frequently are raised on property that is sold, while assessments on similar property, not sold, remain the same. New houses often are assessed at a higher level of full value than old houses because the selling price of new houses is known.

There is also a local tendency to consider the financial ability or the age of the owner in determining the value of the property.

Many local assessment rolls are copied from year to year, thus continuing errors made in the past, as well as the same assessments.

In some tax units, assessment rolls frequently are illegible, or lack enough description of the property to make it possible to identify it, or to assess it to the right person.

The assessment rolls of forest lands reveal that property is frequently assessed to the wrong owner, or separately assessed to two or more different owners, or entirely omitted. Some nonexisting property has been assessed. ☆

New state & local decisions

Tennessee casual sales assessment invalid. Tennessee's sales tax law exempts casual and isolated sales by persons not "engaged in business." A regulation issued by the state tax department excludes from this exemption sales of inventory and other assets made by persons engaged in business even though such sales may be few and infrequent. In accordance with this interpretation, a grocery chain was assessed for taxes on the sale of large quantities of its plant fixtures and automotive equipment which it had acquired and held for use in the course of its business. The court, however, held this assessment invalid. It distinguished between the taxpayer's regular business of selling tangible property and its sale of fixtures and equipment. The taxpayer was not engaged in the business of selling fixtures and equipment, the court said. It gave emphasis to the fact that such sales had presumably borne the sales tax when the good were purchased. *Liberty Cash Grocers,* Sp. Ct. Tenn., 7/29/57.

Second use tax payable if first is refundable. Under Florida's use tax law no tax is imposed on property imported into the state which has previously borne a sales or use tax in another state equal to or greater than the Florida tax. A ruling by Florida's comptroller interpreting this provision held the use tax is due on tax-paid property imported into Florida when the laws of the state to which the tax was paid permit a refund if the property was purchased for use in and shipped to another state. The taxpayer had paid sales and use taxes to New York City on property which was stored temporarily in a supply depot there and later shipped to Florida. In assessing use taxes on this property, the Florida comptroller referred to a ruling by the New York City comptroller's office which permitted a refund within one year after the date of payment of taxes on reshipped property. The court construed the amount received by New York City from the taxpayer as a deposit subject to return upon proof of reshipment rather than a tax payment and ruled that the Florida use tax was properly assessed. *Railway Express Agency,* Sp. Ct. Fla., 7/17/57.

Gas station leases subject to franchise tax. A foreign corporation made wholesale sales of petroleum products and automobile accessories in the District of Columbia. In connection with this business, it leased or subleased a number of gasoline stations in the District which it owned or rented to distributors of its products. The corporation contended that it was not subject to the District's franchise tax on corporate income because it had neither a representative nor a place of business there and consequently was not engaged in business in the area. Its sales were solicited by agents operating from offices in Virginia. Its warehouse was located in Virginia and all its deliveries emanated from there. The court holds that the corporation was not engaged in business in the District; however, it was subject to franchise taxes on the income derived from the result of its service stations. The rental of the service stations was carried on wholly in the District and in accordance with the terms of the franchise tax law was allocable in total to the District. *Cities Service Oil Co.,* D. C. TC, 7/15/57.

Personal property tax upheld on old-model parts. Taxpayer, a manufacturer of farm machinery, sold through local dealers. A branch in Oregon carried a stock of parts, some of which were for old models and moved very slowly, and was subject to tax year after year. The court ruled that the parts were properly taxed as inventory; the mere fact that some items have a low rate of turnover does not change their essential character. The taxpayer had returned these parts at the price at which they would be sold to dealers, less a percentage reduction for obsolescence. Subsequently the county made an additional assessment, increasing the value to the factory cost. The court rules that the factory cost applied to an entire inventory including items which had been unsaleable for years does not necessarily represent the true cash value. Here the burden of proving that the original assessment by the taxpayer did not represent the true value falls on the county and it did not meet the burden. The original assessment is valid. *J. I. Case Co.,* Sup. Ct., Ore., 7/3/57.

Property exemption doesn't prevent use tax. A provision in Alabama's code exempts the property of a charitable organization from all state and local taxes. However, this does not exempt charitable organizations from the state use tax. The court emphasized that the use tax was imposed not on property, but on the storage, use, or other consumption of tangible personal property purchased at retail. *YMCA of Birmingham,* Sp. Ct. Ala., 3/14/57.

The reports here on significant new state tax decisions are provided through the cooperation of the Federation of Tax Administrators. They are adapted from Tax Administrators News.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

Practitioners would limit carryovers of purchased companies to 50% of price

IN RECENT MONTHS we have been printing a good deal in these columns about loss carryovers in corporate acquisitions. We know that these are problems clients raise constantly with their tax advisors and that the law on the subject is difficult and the IRS policy obscure. In December, W. D. Wood, the Dallas CPA, carefully reviewed for us the workings of Section 381, which allows 19 types of carryovers to be used by the survivor in specific tax-free reorganizations, subject to the requirement of Section 382 that if ownership changes greatly (the 50 percentage points rule), the business must be substantially the same.

Then in January we were able to bring you a very thoughtful discussion by a Treasury man, Douglas H. Eldridge, pointing out the greatly different rule that can result in disallowance of benefits (including carryovers) under Section 269 (the revised Section 129 of the 1939 Code). There, the tests are intent, change of control, and a new test based on relationship of price paid and basis of assets acquired.

And while all this discussion of the statute has been going on, the courts have, in dealing with somewhat related problems, applied tests which seem to raise additional hurdles in the use of acquired carryovers. In the corporate department in January, Albert E. Arent discussed at some length the recent Supreme Court decision in *Libson Shops, Inc.* There the question before the Court was whether the surviving corporation in a merger of 17 commonly owned corporations—16 retail stores and a management company—was the "taxpayer" entitled under Section 122 of the 1939 Code to utilize the loss carryovers from pre-merger years of three of the merged corporations. None of the three stores involved had produced any profits after the merger. A unanimous Court held that the tax entity for loss carryover purposes is not strictly the legal entity, but rather the business enterprise which had previously established itself as a tax-reporting unit. Some commentators had feared that this principle might be read into the 1954 Code, though, as Mr. Arent explained, he does not share their fears.

However, the group of outstanding practitioners (see box on page 162) who recently submitted their proposed Subchapter C amendments to the Mills Committee (the Subcommittee on Internal Revenue Taxation of the Committee on Ways and Means) seriously considered adopting the *Libson Shops* test as a proposed new rule on the use of carryovers. They explain the problem, and why they rejected this in favor of a limitation of the carryover to 50% of the price paid for the business.

Limitation on loss carryovers

"The advisory group has carefully reviewed the policy considerations involved in the determination of the circumstances under which limitations should be imposed on the allowance of the full amount of a corporate net loss carryover, whether originating with the same corporation or inherited from a predecessor corporation. The rules of existing law are conflicting and uncoordinated. In fact, there is a serious question whether they do not serve more to blueprint than to prevent avoidance.

"The problems are most acute in Section 382, which seeks to spell out precise rules for specific situations. Generally speaking, Section 382(a) covers stock acquisition and Section 382(b) covers asset acquisition cases. They are separately compartmented, and it is difficult to find any common thread of policy running through the section as a whole. Under Section 382(a), existing carryovers of a corporation are wiped out if, within a two-year period, there is a 50% change in ownership coupled with a failure to continue the corporation's business substantially unchanged. However, these rules apply only if the change of ownership results from a purchase or redemption of stock and there are no limitations if the change of ownership results from a tax-free exchange; e.g., a Section 368(a)(1)(B) reorganization. Section 382(b) imposes limitations in the case of mergers and other reorganizations involving the tax-free acquisition of assets in connection with which Section 381 provides that loss carryovers may be inherited; but, again, there is a hiatus, in that no express limitations are imposed in the case of tax-free acquisitions (with accompanying inheritance of loss carryovers) by way of Section 332 liquidations [complete liquidation of a subsidiary.—*Ed.*]. Moreover, Section 382(b) is operative only where the shareholders of the loss corporation wind up with less than a 20% interest in the combined enterprise. While Section 382(a) results in a complete loss of carryover where applicable, Section 382(b) results in only a *pro tanto* reduction, proportionate to the extent that the loss corporation's shareholders' interest is less than 20%. There is also no requirement in Section 382(b) of continuity of business, as there is in Section 382(a). And taxpayers have made much of the statement in the committee report on the 1954 Code that applicability of Section 382(b) to any extent prevents application of Section 269, regardless of result. The technique (as to the effectiveness of which the advisory group expresses no opinion and which, it is understood, the Internal Revenue Service is certain to challenge) is to give the loss corporation's shareholders, say, a 19% interest, thereby accepting a 5% reduction in carryovers to insure against a much greater, perhaps even a total, disallowance under Section 269.

The Libson principle

"The above discussion is far from exhaustive on the shortcomings of existing law. Can taxpayers avoid both subsections of Section 382 by acquiring the stock of the loss company in a Section 368(a)(1)(B) [stock for stock.—*Ed.*] reorganization and then liquidating the

company under Section 332, where acquisition of the assets directly in a Section 368(a)(1)(C) [stock for assets.—*Ed.*] reorganization would bring Section 382(b) into play? Can the shareholders of the acquiring company purchase the stock of the loss company and then merge it into the acquiring company, relying on the common-ownership provision of Section 382(b)(3) to escape the limitations of the section? It is clear that present law has created a very difficult situation for the Service.

"In seeking a solution to the carryover problem, the advisory group considered the possibility of employing the principle underlying the recent Supreme Court decision in *Libson Shops, Inc.* v. *Koehler* (353 U. S. 382 (1957)), a merger case under the 1939 Code, that loss carryovers can be applied only against income from the business which generated the loss. Such an approach was rejected, however, on the ground that it would result in too narrow a rule, not in harmony with the general carryover scheme of the statute, and that it would be very difficult to draft and apply.

"The advisory group viewed the problem as, basically, one of differentiating between acquisition of a going business, the tax attributes of which would be incidental, and mere acquisition of the tax attributes themselves. This is not to say that the tax attributes of the particular business acquired may not have some financial bearing on negotiations for the sale of stock or for mergers, consolidations, or other reorganizations. This is something that cannot be avoided unless we should abandon entirely our concepts of reorganizations and of the corporate entity as something existing apart from its shareholders. The problem is, to some extent, like that in the *Gregory* case, one of ruling out sham transactions. Continuity will be permitted where the underlying transaction is in harmony with the substance of those concepts, and will be denied where it constitutes nothing but manipulating shadows. But, to the maximum possible extent, it is desirable to particularize the tests to be employed rather than to reply on the exercise of judgment, based on general and necessarily vague principles in every case.

Proposed price rule

"The advisory group believes that the desired result can be accomplished by relating the availability of carryovers to the price paid for the business or stock of the loss corporation so as to eliminate any profit from the acquisition of loss carryovers except as an incident to the acquisition of a substantial going business. The advisory group, therefore, recommends, as a basic rule, that the available carryovers of an acquired business be limited to 50% of the consideration paid for that business. Assuming, for purposes of convenience, a corporate rate of 50%, this means that the value of the business apart from the tax benefit to be derived from the carryovers, must be at least three times the tax benefit, or one and one-half times the amount of the carryovers. For example, if a corporation has loss carryovers totaling $200,000, at least $400,000 would have to be paid for the business in order to have the carryovers fully available. Since the tax benefit to be derived from the carryovers would be only $100,000, the acquired business itself would have to be worth at least $300,000. Actually, however, since it would be an exceedingly rare case where a purchaser would pay dollar for dollar for the hoped-for tax benefits to be derived from the carryovers, a much greater relative value would have to exist for the business itself than three to one.

The foregoing statement of the general principle to be applied is expressed in terms of a case where the entire proprietary interest changes hands. It will also be applicable where there is less than a 100% change in ownership, though, as in the case of existing law, the limitations will operate only where the change in ownership is so large as to demonstrate that persons who did not participate in the ownership during the loss years have taken over the proprietary interest. The draft therefore adheres to a 50% rule relative to change in ownership, but the limitations are independent of the manner of acquisition, whether of assets or of stock, and, in the case of stock, whether taxable or tax-free. In asset reorganization cases this 50% cutoff point corresponds to the 20% cutoff point found in existing Section 382(b).

"Where the change in ownership is less than 100%, the 50% rule relative to available carryover will be applied to the sum of the consideration for the stock involved in the change in ownership and an amount computed for all the other stock. In computing the amount for the other stock, the consideration for the stock involved in the change in ownership will be the starting point. That is to say, the assumed consideration for the entire business is based on the amount which was paid for the portion of the business involved in the change in ownership. If 55% of the business was involved in the change in ownership and the consideration therefore was $500,000, then the assumed consideration applicable to the entire business is $500,000 divided by 55%, or $909,090.90, and the carryovers could not exceed half that amount, or $454,545.45. Of this full amount of $909,090.90, $500,000 would be determined under Section 382(d)(1)(A) and $409,090.90 would be determined under Section 382(d)(1)(B). The advisory group considered permitting carryovers to be retained in some stock acquisition cases on account of stock which did not change hands on the principle that the minority shareholders should be allowed to keep the same amount of carryover as was allocable to their stock prior to the transaction. A major objection to this approach, however, was that the retained carryover so measured would benefit principally the new owners, not the old. Thus, what was regarded at first blush as its primary justification was seen not to be present. Another difficulty was that such a rule would lead to discrimination between various types of transactions without any real differences.

Other applications of rule

"The foregoing example would be equally applicable if the acquisition were by another corporation in a Section 368(a)(1)(B) reorganization or if all the assets of the loss corporation were acquired in a Section 368(a)(1)(C) reorganization, the consideration paid for the stock or assets, as the case may be, being the fair market value of the stock of the acquiring corporation transferred in the reorganization. This would also be true if, in the Section 368(a)(1)(C) reorganization, the loss corporation acquired all the assets of the profit corporation. In all these cases, however, the determination of whether a 50% change in ownership is involved is made against the background of the combined enterprise (except for a retained minority interest in a Section 368(a)(1)(B) reorganization)."

The practitioners group at this point insert several examples of how the proposed rules would work, and then turn to details of their proposed treatment of intercompany holdings and of changes

in ownership within two years of the acquisition. Finally, they discuss the necessity of a clear statement of policy. They say:

"The general rules described above need to be supplemented in order to prevent taxpayers from taking advantage of their specific details. For example, a loss corporation may have assets (perhaps the proceeds of sale of its trade or business), though it no longer is engaged in trade or business. Such a corporation is really a shell in a business sense and must not be permitted to pass its carryovers on to new owners. Similarly, a going business might be acquired with no idea of continuing it, but merely for the purpose of utilizing its carryovers. The proposed mathematical tests would not reach such cases. With these possibilities in mind, the advisory group recommends that its proposals with respect to Section 382 be supplemented by an amendment to Section 269, relating to acquisitions made to evade or avoid income tax. This amendment would take the form of a presumption that an acquisition is for one of the purposes condemned by Section 269 where, subsequent to the acquisition, the corporation does not continue to carry on a trade or business substantially the same as that conducted prior to the acquisition. In other words, the test which now appears in Section 382(a)(1)(C) would be removed from the objective rules of that section and inserted in the more general rules of Section 269. The advisory group has not as yet prepared a draft of these recommendations with respect to Section 269.

"While it is recognized that a test of the nature proposed to be inserted in Section 269 is cast in general terms which are uncertain in application to specific cases, it is believed that such a test is entirely appropriate to the kind of case to which it would be limited under the advisory group's proposal. It is also an integral part of this proposal that the application of the general language proposed to be inserted be described in some detail in an accompanying committee report. This will serve to relieve speculative fears on the part of taxpayers entering into transactions in the ordinary course of their business and will assist the Government in its administrative problem." ☆

Tax accounting for timber: meeting the tax rules

by **LELAND E. FISKE**

When the tax situation of natural resources industries is under discussion, attention is frequently focused on oil and gas. Similar problems of depletion, depreciation, aggregation, reserves and so forth also concern other resources such as timber. In this article, Mr. Fiske discusses this industry, and reviews the natural resources regulations under the 1954 Code, proposed in 1956. Final Regulations have not yet been released.*

TIMBER DEPLETION is limited to a return of cost.[1] No provision is made for an allowance for percentage depletion, as with minerals. The costs to be returned through depletion include the original purchase price of the timber, plus any additional costs which should properly be capitalized, such as costs incurred in reforestation, both for planting and preparation for planting of seedlings. Carrying charges on timber being held in reserve may also be capitalized, at the taxpayer's election.[2] When timber land is acquired in fee, the purchase price should be divided between the timber and the land, on the basis of relative values, since only the timber cost is subject to depletion.

Timber accounts

The taxpayer must divide his timber into timber accounts. A timber account will usually include all of the timber which will go to one mill, except that which is held under cutting contracts, which should be kept separate. It is also permissible to separate timber by species. In Texas, pine and hardwood are customarily carried in separate accounts. There is no fixed rule for setting up timber accounts, and so long as the taxpayer's grouping is reasonable it will usually be approved.[3]

Timber reserves

An estimate of timber reserves must be made by the taxpayer for each timber account. Timber reserves are usually expressed in board feet, being the estimated amount of lumber to be produced from the trees after cutting. They are established by a cruise. This is made by a timber cruiser or engineer, and consists of an actual count and measurement of the trees in selected sample areas, from which sample an estimate can be made of the amount of timber in the whole tract. If carefully made, the result will be reasonably accurate. Timber reserves are usually set on the basis of marketable saw timber at the time of the cruise, and do not include young growth or pulpwood. Timber reserves must be increased each year for the growth of the timber. In Texas this amounts to about 5% a year for pine and 2½% for hardwood. The reserves must be reduced for the amount cut, and also for any substantial amount of timber destroyed by fire, storms, or insect damage, each year. At any time that it appears that the timber reserves computed in this manner are no longer accurate, they should be corrected to the proper quantity by a new cruise.[4]

Computation of depletion

Timber depletion is computed for each timber account by dividing the timber cost by the timber reserves to arrive at a depletion unit per thousand board feet; and then by multiplying this unit by the number of thousand feet cut during the year. The Regulations state that although depletion occurs when the timber is cut, it is deductible when the timber is sold.[5] This result can be obtained by including depletion on unsold cut timber as a cost in the timber inventory. A taxpayer claiming timber depletion is required to file with his income tax return Treasury Form T, giving full information on costs and reserves.

Capital gains

Capital gains from the disposal of timber may arise from the sale of standing timber, the disposal of timber under a cutting contract, or the cutting of timber by the taxpayer, provided the timber has been held for more than six months.[6] Timber is classed as property used in a trade or business, hence gains

or losses are netted with other gains or losses from depreciable and real property so used; the net result is treated as a capital gain if a gain, or as an ordinary loss if a loss. If the timber has been held less than six months, the gain is ordinary income.[7]

Sale of standing timber

If a tract of standing timber is sold, gain or loss results measured by the difference between the sale price and the cost of the timber. If held over six months, the gain will be treated as capital gain.

Disposal under a cutting contract

When timber held more than six months by an owner, under any form of ownership which gives him the right to cut the timber, is disposed of under a cutting contract, the excess of the payments received over the depletion allowable may be reported as capital gain.[8] A cutting contract is a timber lease providing for payments measured by the amount of timber cut, part of which may be paid in advance; these payments correspond to the bonus and royalties under an oil and gas lease. In determining the holding period, the date of cutting shall be considered to be the date of disposal; or if an advance payment is received, the taxpayer may elect to treat the date of payment as the date of disposal. Where an advance payment is made, depletion on this advance payment is computed by spreading the timber cost ratably over the advance payment and the subsequent payments. If part of the timber has been held less than six months when cut, the advance payment must be divided between the part held less than six months and the part held more than six months, in proportion to the relative quantities. Income from the part held less than six months is ordinary income. If the cutting contract expires before all timber paid for has been cut, the taxpayer must treat payments attributable to uncut timber as ordinary income, filing an amended return if necessary.[9]

With respect to the lessee of the timber, all payments made under the cutting contract, whether in advance or at the time of cutting, are to be treated as a cost of the timber, to be returned through depletion allowances. In considering capital gains under cutting contracts, as well as in the case of timber cut by the taxpayer discussed below, evergreens cut for Christmas trees qualify as timber if more than six years old at the time cut and may be subject to capital gain.[10] Any trees cut for cordwood or pulpwood also qualify.

Timber cut by the owner

A taxpayer who cuts his own timber for sale or for use in his business may elect to treat the excess of the value of the timber, on the first day of the taxable year cut, over the cost depletion allowable, as a capital gain, provided the timber has been held for more than six months before the first day of the year. This is a binding election and applies to all timber owned by the taxpayer and to all subsequent years, unless permission is secured from the Commissioner for a change. The value of the timber so established then becomes the taxpayer's cost basis for the cut timber for all subsequent disposals, either as logs or as finished lumber, and is the amount to be included in the timber inventory in lieu of depletion.[11]

Valuation of timber

The value to be set on the timber on the first day of each year is its fair market value on that date as standing timber, that is, the amount for which it could have been sold before cutting. The value must be established by the taxpayer on the basis of the evidence available. The best evidence of value consists of actual sales of comparable timber, preferably in the area and near the valuation date. In determining whether such sales are comparable, several factors must be considered, such as the grade of the timber, its accessibility and the quantity per acre. The log scale used in measuring the quantity sold must also be known. Several different log scales are in use, and for certain sizes of trees a considerable variation in quantities will result from the different scales. Adjustment must be made to compensate for these differences. If no comparable sales are available, resort can be had to appraisals based on the income expected to be realized on the timber products produced from the cut timber, less the costs and proportionate profits of manufacturing. A list of the factors to be considered in timber valuations is contained in the Regulations.[12] Valuation of timber is often difficult. It is a matter of opinion and no exact answer can be obtained. The owner must do the best he can. If the taxpayer makes an honest effort to arrive at a reasonable value, based upon all of the sales and other evidence available, the value will usually have the approval of the Service.

Depreciation

Depreciable property used in timber operations consists principally of the trucks and other machinery used in logging, and the lumber mill. Originally, most timber operators claimed depreciation by the unit-of-production method, based on the timber reserves and the quantity cut each year. Since practically all timber operators are now using selective cutting and reforestation, substantially the same amount of timber is grown each year as is cut, and the reserves are never fully depleted. For this reason the unit-of-production method is no longer applicable. Instead, most operators use the straight-line method. Logging equipment gets hard use and has a short life. A life of three to four years for trucks is usually appropriate. The life of a mill will vary with the size, ranging from 15 years for a small mill to as much as 30 years for a large mill. Timber operators may use the declining balance method or other accelerated methods of depreciation on assets constructed, reconstructed, or purchased new after December 31, 1953.[13]

Losses

Losses of timber frequently occur from fires, ice storms, wind storms and insect damage. When these are minor, they can be taken care of merely by reducing the timber reserves used in computing depletion and spreading the remaining timber cost over the remaining reserves. In the case of a serious loss, the taxpayer may claim a casualty loss deduction in the year the loss occurs equal

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[1] Int. Rev. Code of 1954, Sec. 611.
[2] Prop. Reg., §1.611-3(a).
[3] Prop. Reg., §1.611-3(d).
[4] Prop. Reg., §1.611-3(e).
[5] Prop. Reg., §1.611-3(b).
[6] Int. Rev. Code of 1954, Sec. 631.
[7] Int. Rev. Code of 1954, Sec. 1231.
[8] Int. Rev. Code of 1954, Sec. 631(b).
[9] Prop. Reg., §1.631-2.
[10] Prop. Reg., §1.631-2(e).
[11] Int. Rev. Code of 1954, Sec. 631(a).
[12] Prop. Reg., §1.611-3(f); see also Rev. Rul. 56-434, IRB 1956-36, 12.
[13] Int. Rev. Code of 1954, §167(e).
[14] Int. Rev. Code of 1954, §165; Pioneer Cooperage Co. v. Com., 53 F.2d 43; Oregon Mesabi Corp., 39 BTA 1033.

to the cost depletion applicable to the timber destroyed.[14] In such a case the quantity destroyed should be established by a cruise.

New accounting decisions this month

Loss upon sale of accounts receivable part of net operating loss. Under the 1954 Code, net operating losses do not include loss "not attributable to a taxpayer's trade or business." Under the 1939 Code, the exclusion was for loss not attributable "to the operation" of a business. The IRS rules that the change in language justifies the allowance in an operation loss from the sale of accounts receivable upon the disposition of a business by an individual provided the accounts arose during the ordinary course of the business. *Rev. Rul.* 57-563.

Abandonment loss not operating loss under 1939 Code. An abandonment by a subleasee of a restaurant of the unrecovered basis of his leasehold improvements upon termination of the business cannot be taken into account, under the 1939 Code, in computing a net operating loss. Although the loss is clearly traceable to the abandonment of the business, it is not attributable to the "operation" of a business regularly carried on. [Under the 1954 Code, there is no requirement that the loss arise from the operation of the business.—*Ed.*] *Corey*, 29 TC No. 39.

Deduction for 50% of long-term gains eliminates benefit of net operating loss carryover. Taxpayer had a net operating loss carryover of $12,000 to 1951. In that year, she had long-term capital gains of $73,000, of which only 50% would normally be taxed. Since her 1951 income must be modified, in applying the carryover, by adding back the 50% long-term capital gain deduction ($36,500) which exceeds the carryover, no benefit is received from the loss carryover. [The same result would be reached under the 1954 Code.—Ed.] *Papst*, DC Ore., 11/13/57.

Employee's travel and entertaining expenses cannot be treated as business expenses. Even though salary income must be classified as business income for purposes of computing a net operating loss, travel and entertaining expenses incurred by an employee in the performance of his services cannot be treated by him as business expenses in this computation. [In effect, therefore, these expenses do not increase the net operating loss carryover.—*Ed.*] *Weinstein*, 29 TC No. 19.

Net operating loss won't show up as such on Form 1120. The amount of a net operating loss will not necessarily be the same as the figure on any particular line on Form 1120 where the 85% limitation on dividends received may be applicable. A separate computation should be made. *Rev. Rul.* 57-585.

Dividends on gift taxed to donor. After taxpayer made valid gifts of stock in a controlled corporation to his wife and two sons, the corporation declared a dividend on the stock. The court holds the dividend income to taxpayer was a constructive receipt, even though the wife and two sons reported the amount of the dividend on their tax returns. The transaction on the corporate records indicated that the dividend had not been withdrawn by the wife and two sons, but had been left as a loan by taxpayer. *Jolly's Motor Livery Co.*, TCM 1957-231.

Temporary rental doesn't disqualify residence for nonrecognition of gain. Taxpayer, who had built a house for his own use and lived there for many years, upon being temporarily assigned to work abroad, leased it with the intent of eventually returning to the house. However, because of Federal rent control regulations, he was unable to get possession of the house upon his return and was compelled to purchase another home. He sold the old house and claimed nonrecognition on its sale on the ground it was his residence. The court agrees; the house sold was his residence in spite of the fact it was temporarily rented out. *Trisko*, 29 TC No. 59.

Father not taxable on interest earned in sons' trust accounts; is on wife's. Taxpayer had set up and managed bank accounts in the names of his sons and wife, with himself as Trustee. He is held taxable on the interest earned in the wife's account but not on the interest earned in his son's accounts. Although he controlled the management of his son's accounts, his control was reasonably consistent with his role as father and natural guardian of his sons, and there was no evidence that he withdrew any of these funds for his personal use. However, with regard to his wife's trust account the evidence was to the effect that taxpayer alone made the deposits and withdrawals, there was no delivery of any sort, and there was no intent that the funds would ever be turned over to the wife. *Jolly's Motor Livery Co.*, TCM 1957-231.

CAPITAL GAINS VS. ORDINARY INCOME

Ordinary loss on theatre though closed for six months. A theatre building originally operated by taxpayer as a business enterprise and sold on foreclosure of a mortgage is held to be used in taxpayer's trade or business and not a capital asset. Loss on foreclosure was therefore an ordinary loss not available as a capital loss carryover. [This case was somewhat unusual in that taxpayer was arguing for a capital loss usable against capital gains; presumably he had no ordinary income to offset.—*Ed.*] Taxpayer's argument that the mere discontinuance of the active use of the property for over six months prior to the sale converted the property to a nonbusiness capital asset is denied in the absence of proof of change in the character of the asset. *Kruse*, 29 TC No. 51.

Painter has capital gain on sale of Churchill portrait [*Acquiescence*]. Chandor was an internationally renowned portrait painter. He conceived the idea of painting a group portait of the Big Three at Yalta during 1948, and began by painting individual study portraits of his subjects. When Stalin refused to sit, he abandoned the project but sold the Churchill portrait to Bernard Baruch. He reported the gain as capital on the ground that never before had he painted a portrait except after payment to him of his fee. He said he had no intention of selling the group picture or either study. The Tax Court agreed that the portrait was not held for sale in the ordinary course of his business. [Under a 1950 amendment the Code now excludes an artistic composition from capital assets while it is still owned by the creator.—*Ed.*] *Chandor*, 28 TC 721, *acq.* IRB 1957-49.

No capital gain on lump-sum commutation under employment contract. Taxpayer was entitled to $100,000 payable over six years for services rendered a foundation in connection with its purchase and letting of a tanker. After three years, the foundation sold the tanker and settled its obligations to taxpayer by paying him some $41,000. The court denies the payment was for an interest in the tanker; it was a lump-sum commutation payment for amounts due under an employment contract and is a substitute for future compensation, taxable as ordinary income. The fact that the amounts due under the contract were commutated into a lump-sum figure did not change the basic nature of such payment to proceeds from the sale of a capital asset which would be taxable as capital gains. *Gordon*, 29 TC No. 58.

Transfer of exclusive patent rights was a sale. A transfer of the exclusive right to make, use, and vend diamond-type saw teeth throughout the Dominion of Canada is held to result in capital gain rather than ordinary income. The fact that the parties used the term "exclusive license," or that the mode of payment was measured by sales, or that the licensor had the right to terminate on breach did not negate a sale. *Golconda Corp.*, 29 TC No. 57.

Royalties from patent assignment were capital gain. Taxpayer assigned an exclusive right to make, use and sell under certain patents to a corporation of which he was a 62% stockholder. It was stipulated that taxpayer was not a professional inventor. The court holds the assignment was a sale and that the patent was a capital asset; the royalties are accorded capital gain treatment. [1954 Code Section 1235 provides a specific rule for capital gain treatment to an inventor.—*Ed.*] *King*, DC Tex., 12/13/57.

Payments by sublicensees of ice-cream mix are sales, not royalties. Taxpayer-corporation had acquired from its stockholders the rights and franchise for the manufacture in Oklahoma of a patented ice cream mix. It also owned patented freezers used to manufacture and dispense the mix under a restriction not to remove or use such machines outside the state. Taxpayer entered into 36 subfranchise agreements with "licensees" who were given an exclusive territory within the state. The licensees were to pay a lump sum plus 35 cents a gallon for each gallon of mix used in the freezers, which were to "remain the property of" taxpayer. The Tax Court found the agreements were licenses and the payments both lump-sum and gallonage, were not capital gain. There were too many restrictions on the user to treat the arrangement as a sale. This court disagrees. It holds there was a sale of an asset, the taxpayer's property right in the trade-marked product. However, it remands the case to the Tax Court for a determination of whether that asset is a capital asset or property held for sale to customers in the ordinary course of business. One dissenter would affirm the Tax Court's opinion. *Dairy Queen of Oklahoma, Inc.*, CA-10, 12/3/57.

Distributees have ordinary income on their sale of corporate liquidating dividend. Taxpayers, who had received FHA-insured apartment buildings as a distribution from their corporation, carried on an aggressive and active campaign to sell the property by advertising in leading newspapers and by hiring a real estate broker who was supplied an office, telephone, and office help. The Tax Court concluded the apartments were held primarily for the sale to customers in the ordinary course of business, and the gain realized was ordinary income. This court affirms. *Pool*, CA-9, 12/18/57.

Capital gain on purchased frozen bank deposit. In 1947 taxpayer purchased a frozen bank deposit. The bank transferred the amount on its books and sent taxpayer a formal notice of the transfer and the amount of the deposit. In 1951, the bank paid the frozen deposit. The court holds that taxpayer is entitled to report the gain as capital. The Code treats "evidence of indebtedness . . . in registered form" as a capital asset. The bank's letter was such evidence. *Toye*, DC, La., 11/25/57.

Ordinary income on sale of lots by lumber company stockholders to promote company business. Taxpayers were the principal stockholders and officers of a lumber company which supplied all materials for home construction, and of a building company which was used as an outlet for the products of the lumber company. They owned lots as tenants in common which they sold during the taxable period to the building company and to third parties on the condition that the purchasers buy all their building materials from the lumber company. The Tax Court held the lots were not capital assets but were held by taxpayers primarily for sale to customers in the ordinary course of their business to promote the lumber company. Gains resulting from their sale were therefore taxable as ordinary income. This court affirms. *Lakin*, CA-4, 11/25/57.

Dealer's gain on sale of real property ordinary income. Taxpayer, whose major activity was the purchase and sale of real property, contended that out of 18 parcels sold in 1953, six were purchased as investments for rental income, and that the Commissioner erred in not allowing the gain from their sale to be taxed as long-term capital gain. Taxpayer offered no explanation why the six specific properties should be excluded from his real estate business or how they differed from the other 12 he conceded were business assets. He also failed to prove his argument that the "investments" were sold for the purpose of satisfying tax liens. The court finds that all the properties were held primarily for sale to customers and the gains were properly taxed as ordinary income. *Fronk*, TCM 1957-240.

Capital gain allowed on sale of sand and gravel. Taxpayer granted another exclusive rights to remove sand and gravel from his property for a 15-year period, at a stated price per unit, subject to advance and minimum payments. The Tax Court held that these receipts were ordinary income subject to the depletion allowance, not capital gain. This court reverses. As it reads the agreement, title to the sand and gravel in place was passed; the seller retained merely security for the payments. *Barker*, CA-2, 12/9/57.

DEPRECIATION

Refunds due for barred years reduce taxes in open years. In 1942, taxpayer made machinery and equipment expenditures which, in 1952, as part of a settlement of 1940-1945 taxes it agreed to capitalize and depreciate at a fixed rate. Taxpayer is now suing for this depreciation allowance for the years 1946-1949. However, the court finds those years are barred by the statute of limitations. But it does allow the barred

refund as an equitable recoupment against the still-open 1940-1945 taxes. *M. A. Ferst, Ltd.*, DC Ga., 11/22/57.

Leasehold improvements amortized over useful life; lessor was related to lessee. Taxpayers were partners in a firm which leased property from taxpayers' mother. The Commissioner contends that leasehold improvements constructed by the partnership should be written off over their useful life rather than the lease term as the lease, providing for a nominal rental, was a sham. The jury, weighing the taxpayer's evidence of fair rental value, finds for the Government. *Cohen*, DC Ga., 11/14/57.

Beachfront property used as residence not depreciable though listed for rent. A taxpayer is held not entitled to allowances for depreciation, insurance, and repairs in respect of a beachfront house used as a personal residence. The expenses are personal even though taxpayer was offering the property for rent or sale during the period that he and his family were occupying it, and he also owned and maintained another year-round home. Depreciation was permitted on the property after taxpayer discontinued using it as a residence. *Ford*, 29 TC No. 56.

ACCOUNTING METHODS

Despite six calendar-year returns, fiscal year is correct. Taxpayer had since 1945 filed calendar-year returns; now he claims refund on the ground that his 1951 return should have been for the year ended April 30. The court agrees. Taxpayer did keep records for his proprietorship on an April 30 year; his other records of income are too fragmentary to amount to books. His books being on an April 30 year, the return should have been filed on that basis unless he had permission to file otherwise. He had no formal permission. The filing of calendar-year returns is not, the court states, a matter of consent or acquiescence by the Commissioner. *Gill*, DC Ala., 10/23/57.

Co-op patronage credit not income; payment too indefinite. Taxpayer, a poultry raiser on the accrual basis, was informed by its marketing cooperative that it had allocated to it a patronage refund credit. The cooperative reserved the right to retain all credits and should it sustain a loss it could reduce all credits. Debts of the cooperative and nine years patronage credits had priority over this credit. The Tax Court held that because the cooperative was in sound financial condition, taxpayer must accrue the credit even though payment was deferred. This court reverses, citing among other cases its own decision in *Johnson*, 233 F.2d 952, that a dealer's reserves withheld by a finance company are not income to the dealer. [The Tax Court and the other circuits have not been in accord with *Johnson.—Ed.*] The court notes that the cooperative had paid only 5% of its credits at this time. The credit had no market value and was not acceptable as collateral. The allocation of the credit did not result in income to taxpayer. *Long Poultry Farms, Inc.*, CA-4, 11/8/57.

Liquidating cash basis corporation must report accrued income. The stock of taxpayer was sold to another bank and the new owner voted to dissolve taxpayer. Even though taxpayer was on a cash basis, the Commissioner required it to include in its last return interest income accrued up to the date of dissolution. The IRS takes the position (*Rev. Rul.* 255, CB 1953-2, 10) that a cash basis taxpayer who has performed substantially all the services necessary to establish its right to income, must accrue that income in its year of liquidation. The court agrees that this is a proper exercise of the Commissioner's right to require an accounting method that properly reflects income. *Idaho First National Bank*, DC Idaho, 12/2/57.

Change in accrual date for Ohio personal property tax. The accrual date for Ohio personal property taxes for 1957 and later years is December 31, the date as of which the property is required to be listed. The IRS had held under prior law that these taxes accrued January 1. It follows that taxpayers will accrue two taxes in 1957. TIR 65.

Capital stock tax proper accrual despite repeal before payment. Taxpayer was on a fiscal year ending August 31. For the year ended August 31, 1945, taxpayer accrued and deducted the capital stock tax to be paid June 30, 1946. This tax was levied for year beginning July 1 and was payable at the end of the year. However, in November, 1946, the tax was repealed. Following the annual accounting concept, the court allows the deduction as being a proper accrual based on the facts prevailing at the end of the taxable year. *Rahr Malting Co.*, DC Wisc., 12/16/57.

Regulation requiring down payment for installment sale invalid (Old Law). The court holds that the gain on sale of land and gravel in place was properly reported on the installment basis under the 1939 Code, even though no down payment was received in the year of sale. This case had been remanded by the Ninth Circuit after reversing the Tax Court finding that the transaction was a lease, not a sale. For this reason the court says it is bound by the Ninth Circuit's decision in *Gilbert* (241 F.2d 451) that the regulation denying the installment method unless a down payment is made is invalid. In the *Gilbert* case, the court had pointed out that the Code itself made no such requirement. [The 1954 Code specifically states that the installment method may be used if there are no payments in the year of sale.—*Ed.*] *Gowans*, TCM 1957-233.

Bonus credited to dealer's reserve is income though not withdrawable. Finance companies allowed taxpayer a share of the finance charges as a bonus or inducement for doing business with them. He was a dealer in trailers who financed installment notes and conditional sales contracts. The companies would credit the dealer's reserve account with his share of the finance charges as well as the "holdbacks" from the face amount of the discounted paper. The dealer claimed that the portion of the credit which represented finance charges was not income to him until the charges became subject to immediate collection. However, the court holds the entire yearly increase in credits, including the portion of the finance charges, represents accrued income to the dealer and is taxable in the year credited. *Wiley*, TCM 1957-236.

Unconstitutional tax allowed as a deduction in year of accrual. A taxpayer had accrued on its 1948 return township taxes which were actually paid over in 1948 and 1949. In the latter year, the taxes were found to be unconstitutional. The court holds the original deduction in 1948 will be allowed to stand and the refund of tax, if there is ever any, will be taxed in the year when received. *Denise Coal Co.*, 29 TC No. 61.

Auto dealer cannot exclude credits in

dealer's reserve account. An accrual basis auto dealer assigned its conditional sales agreements to a finance company. The company remitted part of the sales price to the dealer and credited part to a special dealer's reserve account to be held until such time as the amounts equalled or exceeded 3% of the outstanding balance on the contracts. Even though the amount in the special reserve account did not exceed 3% of such balance during the taxable years, the court holds that the full sales price is accruable to the dealer at the time of sale. The only thing that will prevent the dealer from receiving the full sales price is the possibility that the purchaser will default, and that contingency is held not sufficient to defer the accruing of income that has been earned. *Evans Motor Co.* 29 TC No. 62; similarly *King Motor Co., Inc.,* TCM 1957-242.

Bad debt method was reserve; reduction was income. Taxpayer, who ran a retail furniture store, had claimed bad debt expense in the thirties but had collected many of the bad accounts in 1941-1943. He did not include these recoveries in income. In 1943 and 1945 (the years here at issue) a new accountant determined that his reserve was excessive and transferred to net worth all in excess of a fixed percentage of outstanding receivables. The Commissioner asserted that the excess reserve is income. The taxpayer argues that he was really on the specific-write-off method of accounting for bad debts, the specific recoveries were income when collected [presumably closed years—*Ed.*] and the adjustment in the reserve has no effect on income taxes. The court holds that while taxpayer's method was somewhat irregular, he was on the reserve method —he determined the addition to the reserve in the thirties by totaling his doubtful accounts rather than using the more common method of a percentage of sales or of outstanding accounts. Consequently the adjustment to the excessive reserve is taxable income. *Lutz,* 29 TC No. 53.

20-year-old costs allowed as inventory value of reworked ores. From 1900 to 1943 taxpayer had preserved ores from which it had extracted copper; in 1943 it began to rework those ores to obtain more copper. For the taxable years here in question it used the ores left as residue in certain loss years in the twenties. At that time, all operating costs had been charged on the books as expenses. The taxpayer now argues that it should be allowed to deduct the portion of the costs properly allocable to the residue in the current year as it reprocesses it. In effect, it would correct its earlier accounting to assign an inventory value to the residues. The court holds it may do so; it was not bound by its earlier practice. It must be allowed its true costs now. Two judges dissent on the grounds that allowing the deduction violates the principles of annual accounting. *Quincy Mining Co.,* Ct. Cls., 12/4/57.

Revised inventories not substantiated by taxpayer. Taxpayer was a bankrupt, and its trustee is resisting a claim by the Service for additional taxes and counterclaiming for a refund. The trustee's claim is based on a reduction of the inventory from that reported on the tax returns. However, the testimony supporting the reduction is conflicting and indefinite. The court, therefore, accepts the findings of the referee. The trustee also failed to prove the deduction claimed for purchases, and a partial disallowance of this item is approved. *Holzapfel's Sons, Inc.,* CA-7, 12/11/57.

Fur-bearing animals inventoriable as "livestock." A taxpayer engaged in the business of breeding and raising chinchillas, mink, foxes or other fur-bearing animals may use any of the inventory and accounting methods accorded farmers. *Rev. Rul.* 57-588.

Brick veneer building has 25-year life. A building of four-inch brick veneer constructed on soil having a tendency to expand and contract and thus crack the walls of the building is found to have a useful life of 25 years for depreciation purposes. *St. Denis Securities Co., Inc.,* TCM 1957-247.

DEDUCTIBILITY

Ordinary loss deduction on agreement to bear another's stock losses. Although taxpayer and his ex-wife were divorced, he still handled her financial affairs. He suggested the purchase of certain stocks by her and agreed to bear any losses she might incur on these stocks if he would receive one-half of any profits. Dividends were to belong to her. Ultimately the stocks were sold at a loss. The court holds the payments made pursuant to this agreement were fully deductible as losses on a transaction entered into for profit. Taxpayer had no ownership in the securities and was not engaged in a joint venture. *Paddock,* DC Calif., 11/15/57.

Taxes which became lien prior to sale of property not deductible by buyer (Old Law). Property taxes which had been assessed and had become a lien in 1953 prior to the time when taxpayer assumed them in connection with purchase of real property, became part of the cost of the property and could not be deducted as an expense when paid in 1954, after the purchase. [Under the 1954 Code real property taxes are apportioned between buyer and seller in accordance with period held.—*Ed.*] *Ford,* 29 TC No. 56.

"Compensation" not deductible; it was a disguised payment for stock. Taxpayer bought the stock of a corporation wholly owned by three brothers. He paid two of them $98,000 and the third one $50,000 for the stock plus $48,000 he claimed as compensation under an employment contract. The court holds the $48,000 paid by taxpayer was not deductible as compensation but was part of the cost of the stock purchased. *G. Haiss Mfg. Co.,* TCM 1957-241.

OTHER DECISIONS

Cancellation of debt by merchandise creditors not gratuitous. Creditors of taxpayer, a coal and oil dealer, agreed to accept payment of $26,000 in full settlement of their accounts in the amount of $96,000. After the debt cancellation, taxpayer was solvent in the amount of $28,000. The Tax Court held the creditors obtained the best settlement possible; there was no intent to make a gift. Ordinary income was therefore realized to the extent of the debtor's solvency after the cancellation. The tax benefit rule was held not applicable because of the absence of any relationship between the cancellation and losses incurred in the purchase and sale of coal and oil in a prior year. This court affirms. *Capitol Coal Corp.,* CA-2, 12/6/57.

Cemetery building trust fund held taxable. Taxpayer, a cemetery corporation organized for profit, sold cemetery lots under a contract which required it to pay 15% of the purchase price into a trust fund for the erection of a chapel

and administration building. It excluded this 15% from its gross income. The court, however, holds it taxable thereon. It had substantial control of the trust. It could modify the trust except to recover the payment; the trustees were the executive committee of the taxpayer. *Gracelawn Memorial Park, Inc.*, DC Del., 12/2/57.

Collections from milk customers, later illegally refunded, not income. Taxpayer collected from its milk customers the price fixed by law under an agreement to refund part (such a refund being illegal). Following *Pittsburgh Mill*, 26 TC 707, the court holds the excess was not income to it when originally received, and should not have been included by the dairy company in computing and reporting its gross income. In effect the parties agreed upon a lower price. *Rosedale Dairy Co., Inc.*, TCM 1957-243.

Ordinary income on payment of open account with devaluated currency. Taxpayer, an American travel agency which was a subsidiary of a Norwegian parent, obtained travel services and accommodations for its patrons from the parent on a running account of credit. The amount payable to the parent was accrued at the exchange rate existing early in 1949, whereas actual payments were made later at a lower exchange rate due to devaluation of the krone. The benefit of over $25,000 realized by the American agency by payment of its obligations with devalued krone is held to be ordinary income resulting from an independent investment or speculation in foreign exchange. *Bennett's Travel Bureau, Inc.*, 29 TC No. 38.

Failed to prove nonbusiness bad debt. Taxpayer advanced $5,725 to one White on unsecured notes in order to become a silent partner with him in an outdoor advertising program. She claimed a deduction for the advances two years later as a nonbusiness bad debt. After considering the contradictions in her testimony, its inherent implausibility, its inconsistency with written documents in evidence, and her demeanor on the witness stand, the court concludes that taxpayer failed to sustain her burden of proving that the advances were unpaid or worthless in the taxable year. *Horne*, TCM 1957-212.

Loan to related sales corporation deductible as business bad debt. Taxpayer manufactured jewelry cases and boxes in Buffalo as a sole proprietor. He created a separate sales corporation in California and sold it raw materials and merchandise from his Buffalo plant. Loans of some $64,000 made by the proprietorship to the California corporation over a four-year period are held to be proximately related to the business of the proprietorship and hence deductible in full as a business bad debt when the corporate operations ceased. *Weil Estate*, 29 TC No. 40.

No income on sale until year of payment. Taxpayer is held not to have received income in 1948 upon transfer of automobile parts and equipment from his corporation to a trade school; notes in payment were issued to him personally and were dated 4|15|49, due six months later. On these facts the court finds no evidence that taxpayer personally received anything in 1948.. *Jolly's Motor Livery Co.*, TCM 1957-231.

Property was acquired by purchase; basis is cost not predecessor's basis. Taxpayer contended that it should be allowed as invested capital the basis of the assets in the hands of the predecessor owner, a receiver in bankruptcy to a court order for sale. The district court found that the transfer was a sale, not a tax-free reorganization. This court affirms. *Select Theatres Corp.*, CA-1, 12/3/57.

Failure to use isn't abandonment. A loss in 1943 from the abandonment of a building formerly used as a hosiery mill is denied in the absence of evidence of permanent abandonment in that year. Mere nonuse of property is not sufficient to constitute an abandonment. Furthermore, taxpayer failed to show that the salvage value of the building was less than the tax basis. *Lutz*, 29 TC No. 53.

Growth Savings Certificates taxed like E bonds. Some banks issue Growth Savings Certificate at a discount. The certificates increase in value at stated intervals and, the IRS rules, are to be taxed in the same manner as Series E savings bonds. Accordingly, a cash basis taxpayer may defer reporting the gain until surrender of the certificates, or he may elect to report the increments in value annually. *Rev. Rul.* 57-452.

NEW DECISIONS ON DEPLETION—SPECIAL INDUSTRIES

Payments to strippers deductible in determining "gross income from property." In computing percentage depletion, gross income from the property is always computed by deducting royalty and other payments depletable by the recipient. At issue here is whether taxpayer must deduct payments to coal strippers and that depends on the nature of the strippers' interests. Taxpayer entered into contracts with various stripping contractors to mine the coal on land it owned or leased. The strippers used their own machinery and built roads for access to the pits and other facilities necessary for conducting their operations. Taxpayer sold the coal which was mined by the strippers. The Tax Court determines that it must deduct from its gross income in computing percentage depletion the amounts paid to the contract strippers, since they had an economic interest in the property. *Denise Coal Co.*, 29 TC No. 61.

Cost of surface land destroyed by strip mining recoverable only through depletion. Taxpayer was engaged in strip-mining operations. It acquired various tracts of surface lands overlying coal deposits which it owned. The portions of the surface which were strip mined were completely destroyed. Taxpayer is denied a deduction for the destruction as a business expense or as a loss. However, it is held entitled to additional depletion on account of the exhaustion of its investment in the surface lands by adding the cost of the land to the cost of the coal and dividing the number of tons into the total cost. [If percentage depletion is larger the taxpayer will derive no benefit from the increased basis, since the amount allowable is dependent on income, not basis.—*Ed.*] *Denise Coal Company*, 29 TC No. 61.

Though timber didn't qualify for special rule, it may be capital asset. Taxpayer at no time engaged in logging activities; it sold timber to others who agreed to do the logging. Since the timber sales were the only activities carried on by the company, the Tax Court held the timber was "property held for sale to customers in the ordinary course of business." Accordingly, gains derived

from the sales could not qualify as capital gains under Section 117(k) (the special rule giving capital gain on certain sales of timber). [The IRS announced its nonacquiescence in this decision and issued a ruling (*Rev. Rul.* 57-90) that capital gain on cutting of timber (117 (k)) was allowable regardless of the taxpayer's purpose in holding the timber.—*Ed.*] The provisions of Section 117(k) allow capital gain on cutting of timber only if the owner maintains an economic interest in the timber. This court agrees with the Commissioner that the taxpayer's purpose is irrelevant under 117(k). However, this taxpayer is not entitled to capital gain under 117(k) because it did not retain an economic interest in the timber as required. But, the court continues, taxpayer should have been allowed capital gain under the general rule. On the record, the Tax Court erred in saying it held the timber for sale to customers; there was no evidence supporting the finding. Ordinarily, taxpayer's failure to raise this point (general rule) in the Tax Court would prevent it later bringing it up. Justice here, however, demands a remand for the Tax Court to determine whether the timber was a capital asset under the general rule. *Ah Pah Redwood*, CA-9, 12/13/57.

Determination of 3/1/13 cost upheld. The Tax Court determined the unrecoverable 3/1/13 basis of timber on which it allowed current depletion. A loss on a sale of land held on 3/1/13 was disallowed based on that determination. The taxpayer contends the value should be determined on a blockage basis by aggregating its timber tracts. This court affirms the Tax Court, however, because the evidence was insufficient to support a blockage value. *Alabama Mineral Land Co.*, CA-5, 12/30/57.

Fair market value of timber determined. A taxpayer owning timber may elect to treat the cutting of the timber as a sale at fair market value on the first day of the taxable year in which it is cut. The experts for taxpayer estimated values twice as high as those for the Government. The court sustains taxpayer. Its estimates were based on sales of property like its own. *Cascade Lumber*, DC Wash., 6/17/57.

Share in lumber sales to non-owner is compensation, not capital gain. The district court held that the contract between the parties clearly stated that taxpayer was to have no interest in the logs he was to cut and that he was only to be paid for his services. Hence, he is not entitled to treat his income as being received from the disposal of such logs. The circuit court affirms. *Ellison*, CA-9, 5/27/57.

Mutual-ditch assessment for capital improvements not deductible. Taxpayer-farmers receive their water from certain non-profit mutual-ditch companies. They claimed as business expense deductions the assessments paid to these companies. The Commissioner contended that in view of the use to which these payments were put, e.g., retirement of bonds and purchase of capital items, they must be treated as capital. This court upholds the Commissioner's determination, reversing the district court which had allowed the deduction. The payments went to expand the water distribution system and thus are capital in nature. *Akin*, CA-10, 10/19/57.

Bagged, expanded perlite is first commercially marketable product. Taxpayer's perlite could not, the court finds, be sold in any other form than an expanded bagged aggregate because of its soft consistency. The court holds taxpayer is entitled to compute his percentage depletion on bagged expanded perlite. *Utco Products, Inc.*, DC Utah, 10/24/57.

Use test for shale depletion. The 15% depletion rate applies to oil shale mined solely for its kerogen content while the 5% rate applies to oil shale mined and used for riprap, ballast, road material, rubble, and concrete aggregates. *Rev. Rul.* 57-529.

End-use test for quartzite depletion abandoned. In the light of the Service's acquiescence in *Spencer Quarries*, the end-use test will no longer be applicable in determining the depletion rate for natural quartzite deposits. *Rev. Rul.* 57-584.

End-use test not applicable in determining depletion rates for quartzite [*Acquiescence*]. Although all the deposits quarried and sold by taxpayer were quartzite within its commonly and commercially accepted meaning, the Commissioner argued that taxpayer was not entitled to the 15% quartzite depletion deduction, but to the general 5% allowance, because the end use of most of the deposits sold was for construction rather than refractory purposes. The court allows the 15% rate. As the Code had specifically provided a stated rate for quartzite, the end use of the mineral was immaterial. *Spencer Quarries*, 27 TC 392, *acq.* IRB 1957-49.

Percentage depletion allowed for peat, not moss. Depletion is allowable for the residuum of partial decay of moss, shrubs and trees. It is not allowable for moss before it becomes peat. *Rev. Rul.* 57-336.

CCC certificates are 100% government-guaranteed loans. In computing their bad debt reserves, banks use a formula based on experience. However, they must exclude from the experience 100% government-guaranteed loans. Certificates of interest issued by the Commodity Credit Corporation, held by commercial banks, are 100% government-guaranteed loans for this purpose. *Rev. Rul.* 57-509.

Capital gain on assignment of oil payment. The report of the case does not make clear the nature of the oil payment interests taxpayer assigned. The judge's discussion indicates that he finds the transaction less like *Hawn* (231 S.W.2d 340) (assignment of oil payment in consideration for a residence is assignment of future income, not sale of a capital asset) than *Caldwell* (218 F.2d 567) (assignment of carved-out oil payments to a foundation for cash and notes is sale of a capital asset). Taxpayer realized capital gain. *Witherspoon*, DC Tex., 1/30/57.

Sale of "oil payment" was in substance delayed bonus payment. In a leasing agreement covering oil and gas properties, taxpayers as lessors retained the usual royalty and also received a cash bonus and an oil payment. With respect to the oil payment, the lessees agreed to purchase it at a reduced price after two years. The reduced price plus the cash bonus were equivalent to the $15-per-acre bonus taxpayers had demanded during the negotiations. Looking to the substance of the transaction, the court finds the so-called sale of the oil payment back to the lessees was intended as an additional cash bonus. The proceeds are thus ordinary income rather than capital gain. *Frey*, DC Tex., 11/2/57.

TAX PLANNING AND
Business management
EDITED BY CHARLES S. LOWRIMORE, Sr., CPA

How to use insurance-funded buyout plans today; tax safety grows with new cases

by **A. R. KEHOE**

Buy-and-sell agreements funded with insurance have usually followed one of two basic forms the cross-purchase type or the entity type. From time to time, one type has enjoyed greater popularity than the other, mainly because of influence of the tax laws. Mr. Kehoe explores the advantages and disadvantages of each type today, in the light of the recent tax cases involving the taxability of premium payments and of redemptions. He warns against hybrid types, and points out that the whole area is one requiring the greatest caution.*

UP UNTIL RECENT weeks court decisions have had an adverse influence on the wide-spread use of buy-and-sell agreements funded with insurance, two distinct types of which are popular today. This influence is unfortunate, especially where it kills their use entirely, because these agreements are usually found in small, closely held business which Congress wishes to favor.

Under the cross-purchase type of such agreements, several partners or stockholders agree in advance that the partnership interest or the stock of the first to die will be purchased by the survivors. In normal circumstances, in order to fund the purchase, the individual partners or stockholders take out insurance on the lives of the other partners or stockholders with themselves as beneficiaries. In the event of death, the proceeds are used to purchase the interest of the deceased.

In the entity type, the partnership or corporation, as distinguished from the individual partners or stockholders, agrees to buy the interest of the deceased partner or stockholder and the purchase is funded with insurance on the lives of the partners or stockholders payable to the partnership or the corporation.

From a tax standpoint, cross-purchase types are generally less desirable, because after-tax dollars are used to pay the premiums or the purchase price. In addition, cross-purchase types have been recommended against because of the possibility of the inclusion in the decedent's gross estate of both the business interest and the insurance proceeds (but see *Rev. Rul.* 56-397 (IRB 1956-34, 14)). And finally, cross-purchase types have been discouraged by the uncertainty of whether or not the buyer will get a cost basis for the stock or partnership interest equal to the proceeds used or only equal to the premiums paid. From a nontax standpoint, cross-purchase types are less desirable because of the problems of rearranging policies on the other lives on death. Cross-purchase types have, of course, been discouraged where there are an unwieldy number of partners or stockholders involved. But it is the tax factors that have played the main part in the ascendancy or descendancy in popularity of the cross-purchase buy-and-sell agreement.

On the other hand, the entity type has not been without its problems and, especially, tax problems. The first came in the *Legallet* case, 11 BTA 294, decided in 1940. This case involved a partnership. The court held that since the partnership, as distinguished from the individual partners, owned the insurance, the purchasing partner did not get a stepped-up cost basis in the partnership assets acquired to reflect the insurance proceeds paid to the deceased partner's estate. A further deterrent to the entity type came in 1942 under Section 811(g)(2) of the Code providing for inclusion of the insurance proceeds in the estate of a decedent if he paid the premiums directly or indirectly. There was substantial apprehension of the possibility that insurance proceeds would be included in the deceased partner's estate if the partnership as such owned the policies on the premise that the deceased partner indirectly paid the premiums for the policy on his own life. It had been fairly well established that these were not serious problems when the 1954 Code came along and by abolishing the premium payment test, obviated them completely and the entity type again enjoyed ascendancy in popularity.

In the last several years there have been a number of Tax Court and courts of appeal decisions indicating problems in connection with the entity type of agreement relating to corporate interests and a period of decline in popularity of that type has again set in. The entity type of buy-and-sell agreement involving corporate interests is essentially a stock redemption agreement and that is our main concern here.

Danger of hybrid agreements

It is submitted that these recent cases are not as dangerous as some have thought and either type of buy-and-sell agreement can be used without too much danger. The type should be selected on the basis of the practical problems involved rather than the tax dangers. These recent cases that have caused so much consternation have all involved hybrid arrangements combining the characteristics of both the cross-purchase and the entity type of stock purchase agreements and that has caused the tax problems. If the adviser drafting the instruments can keep the interested parties from substituting the characteristics of one in the other, such as adding the right of complete access to the insurance proceeds, a feature of the cross-purchase type, to the entity type, and if the conventional form is carefully followed, the entity type is just as safe today as it has been in the past. If the greedy stockholders, however, want to go beyond the scope of the conventional type of entity agreement and keep the insurance safe from creditors,

* This article has been adapted from a paper presented to the Estate Planning Council of Seattle.

then tax trouble is a distinct possibility.

Under the conventional stock redemption agreement, the corporation is a party to the agreement and binds itself to retire the stock of a deceased stockholder at some agreed-upon fair valuation or a value to be determined under some agreed-upon method. The purchase is funded with life insurance owned by the corporation, either in its own name or through a trustee, the corporation having all incidents of ownership and being the named beneficiary.

The IRS attack

The Commissioner has attacked stock redemption agreements from all possible angles. Initially, he treated the redemption amount as a dividend to the selling interest. This approach was foreclosed by the 1954 Revenue Act which precludes dividend treatment where all of the stock of a stockholder is purchased unless the rules of attribution are applicable. The Commissioner's second approach was to treat the purchase price as a dividend distribution to the remaining stockholders, on the theory that the direct purchase was merely a shortcut for distribution of funds by way of a dividend to the other stockholders and purchase by them from the decedent's estate. Variations of the problems presented by this approach have long been with us. It has always been dangerous for a stockholder to contract for the purchase of other stockholding interests and then, as a tax afterthought, have the corporation take over his contractual obligation. The Commissioner, in these instances, has been eminently successful in taxing the buying stockholders on a dividend distribution even though the corporation ultimately became the purchaser. Another line of attack on the part of the Commissioner has been to tax under the old Section 102 of the 1939 Code (Section 531 of the 1954 Code) where the corporation deliberately builds up surplus for purposes of funding a buy-and-sell agreement involving stockholders. The Commissioner has successfully argued that the retention of earnings for this purpose and the failure to pay them out as dividends justifies the application of the special surtax provided by those sections.

The important aspect of the stock redemption agreement and the one that seems to have been a pivotal point as far as the courts of appeal in the various circuits are concerned, as reflected in these recent decisions, is the fact that the corporation is the beneficiary of the insurance proceeds and that creditors of the corporation have access to the proceeds ahead of the rights of the selling stockholder interest. The problem that has bothered the Tax Court most is the problem of whether or not there is corporate business purpose at all in such agreements, and when the agreement is hybridized by protecting the insurance from corporate creditors and giving the stockholders assurance of access to the proceeds, that tips the scale, and it's fatal as far as that tribunal is concerned.

Before looking at these recent cases on stock redemption agreements, it is helpful to reexamine some of the background cases so that basic principles can be dissected and be better understood.

Tax Court position

The landmark case is that of *Emeloid Co.*, 14 TC 1295. This case involved the question of whether a loan was obtained for corporate business purposes where the corporation solicited the loan in order to have funds with which to purchase single premium key-man insurance covering the lives of its two sole common stockholders who were also its key executives. Sometime after the key-man insurance was purchased, the corporation and the stockholders entered into a stock redemption agreement with the key-man insurance converted to fund the stock redemption agreement. The conversion was accomplished through setting up a trust. It is important to note that apparently under local law the insurance remained subject to creditors' claims ahead of the claims of the selling stockholder's interest.

The technical issue in the case was whether or not interest on the loan originally incurred for the purchase of the key-man insurance could be included in computing the excess profits tax liability of the corporation.

The Commissioner argued that there was no corporate business purpose in the arrangement and the Tax Court went along with that argument, stating: ". . . the true purpose of the insurance policies, and thus likewise the indebtedness incurred to purchase them, was to provide available funds at the death of either Leeds or Madan, so that the survivor would be readily enabled to purchase his deceased associate's interest. The benefit to the petitioner of such a transaction appears highly remote. Instead of being supplied with funds to tide it over a period of adjustment upon the death of the key employee, petitioner, under the trust agreement, would be compelled to use the life insurance proceeds to purchase and retire the stockholdings of its deceased officer. Concluding, as we must from the evidence before us, that the policies here were purchased as part of a stock purchase plan for the personal interests of petitioner's two common stockholders and not for any business purpose of petitioner itself, we must approve the respondent's determination."

It should be noted that the Tax Court did not always have trouble finding corporate business purpose in stock redemption agreements providing they were not so closely patterned to stockholders' convenienece. In *Edgar M.* Docherty, 13 BTC 462, the issue involved the taxable or tax-free nature of a reorganization. The Tax Court found that the purpose of the reorganization was to facilitate the purchase of the shares held by any of the four shareholders of the corporation in event of his death and thus assure the continuity of Harmonious ownership and control. The Tax Court held that the recapitalization reorganization was tax-free as serving a legitimate business purpose.

In *Fred F. Fisher*, 6 TCM 520, the Tax Court found corporate business purpose where a family group of stockholders was feuding and one member of the family arranged to have the corporation buy the other's stock to preclude a receivership action on the part of the dissident family member. The Commissioner argued that this was a dividend as to the stockholders other than the selling stockholder but the Tax Court found for the taxpayer, stating that there was corporate business purpose in "promoting harmony in the conduct of the business and securing it from annoying interference and threats of legal proceedings."

In *Snite*, 10 TC 523, a corporation purchased some of its shares from two of its main stockholders, allegedly to provide treasury stock for resale to key employees. The business purpose asserted was that it was necessary to make this stock available to assure the loyalty of the key employees. The Tax Court held that the purchase by the corporation of its own stock with this end in view served a legitimate corporate business purpose and held that the purchase

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was not a dividend distribution to the selling stockholders.

Results on appeal

The *Emeloid* case was reversed by the Third Circuit (189 F.2d 230). The appeals court said: "Harmony is the essential catalyst for achieving good management; and good management is the *sine qua non* of long-term business success."

The court noted that the insurance in the *Emeloid* case was subject to creditors' claims ahead of stockholders' claims under local law, but based its decision squarely on the presence of corporate business purpose in the entire arrangement. The court pointed out that the corporation was satisfied with its management and anticipated that should one of its key stockholders die, those beneficially interested in his estate might enter into active participation in the corporate affairs and possibly introduce an element of friction. The trust agreement provided the corporation with a method of subjecting all potential purchasers to a screening test. The corporate business purpose was continuity in the management and policies of the company. The court found this an adequate business purpose to enable the corporation to have the interest on the loan considered for excess profits tax purposes. The taxpayer's victory was widely celebrated in insurance fields.

Recent cases

With this as background, let's now turn to the recent cases in which the courts, and especially the Tax Court, have created some doubt as to the entity or stock redemption type of buy-and-sell agreements for corporate interests. The three leading cases of this recent group are *Oreste Casale, Henry E. Prunier* and *Sanders*. It is submitted that a careful analysis of these cases shows that hybrid aspects of both cross-purchase and entity types of buy-and-sell agreements were involved and, very likely, if the basic attributes of the entity type were followed completely, the tax problems would not have arisen. [For an analysis of these cases, see 7 JTAX 258.—*Ed.*]

There are two other recent decisions of current interest on the questions involved in these stock redemption agreements. These are *Doran*, 15 TCM 629, and *Holsey*, 22 TCM 107.

The *Doran* case represents another situation where the normal buy-and-sell pattern was changed and, for that reason, tax trouble was incurred. In the *Doran* case, the stockholders of a closely-held corporation, at a stockholders' meeting, adopted a stock purchase agreement under which three of its officers acted as trustees. The officers applied for the insurance policies on the lives of the stockholders and named themselves beneficiaries of each policy. Upon the death of any stockholder, the trustees were to receive the proceeds of the policy and disburse them to the surviving stockholders. The agreement stated that the proceeds received might be used to purchase the stock of the deceased stockholder and each stockholder bound his estate, in the event of his death, to offer to sell his stock to the survivors.

The premiums on the policies had been paid at all times by the corporation, but it did not carry the policies on its books as an asset, nor did it claim a tax deduction for the premiums when paid, nor did the stockholders report the premiums as income. The problem arose on the death of one of the stockholders. The trustees received the insurance proceeds and applied the proceeds on the purchase of the stockholder's stock in behalf of the surviving stockholders.

The Tax Court, no doubt chafing under prior reversals, held that in receiving the insurance proceeds and applying them on the purchase of the stock, the trustees were acting on behalf of the corporation rather than the stockholders and that the procedure amounted to the corporation receiving the proceeds of the policy and distributing them as a taxable dividend to the stockholders.

The Court of Appeals for the Ninth Circuit reversed the Tax Court, holding that the trustees actually represented the individual stockholders and, therefore, the insurance proceeds were not a taxable dividend to the surviving stockholders.

Undoubtedly, under the circuit court's decision, while the proceeds of the insurance escaped dividend tax treatment, if the court were perfectly consistent there would be no question but what the premium payments on behalf of the stockholders would be taxable as constructive dividends to them.

In any event, the reversal again indicates the lengths the circuit courts will go to rescue the agreements from the tax dangers selfish stockholder interests can get them into.

The *Holsey* case points up the danger of getting stockholder negotiations mixed up with corporate negotiations. Here, a stockholder desiring to sell his stock in a corporation gave a prospective purchaser an immediate option to buy 50% of his stock in the corporation and a further option to buy the other 50% later on. The purchaser exercised his first option and, some twelve years later, apparently decided to buy the other 50% of the stock. Undoubtedly after consulting his tax advisers, he assigned the option on the second 50% to the corporation and had the corporation exercise the option at a time when the corporation had earned surplus of some $300,000 more than the purchase price of the stock, which was $80,000. The Tax Court held that the corporation's purchase was equivalent to a dividend distribution to the 50% stockholder who had purchased his stock originally.

What was done here has always been very dangerous and has led to tax difficulty in the past. It is never safe for a taxpayer to negotiate or contract for purchase of stock and then, as an afterthought, have the corporation take on the actual purchase if it has surplus. Invariably, the courts will hold that this is a purchase without corporate business purpose and therefore will either treat it as a taxable dividend to the stockholders or will find some other method of applying a tax detriment which was not considered when the transaction was consummated.

The Court of Appeals for the Eighth Circuit, in *Tucker*, 226 F.2d 117, had ruled otherwise in a like case but the Tax Court is not apt to follow the Eighth Circuit's reasoning in this type of case.

The accumulation hazard

The last of these recent cases is *Pelton Steel Sasting Co.* (28 TC No. 20, *aff'd* CA-9, 1/7/58), and involves the Commissioner's third approach in his attack on these stock redemption agreements. The case suggests the premise that perhaps buy-and-sell agreements should be funded with insurance because there are significant tax dangers in attempting to

fund the agreements by accumulating earnings and building up surplus.

The *Pelton* case involved Section 102 of the 1939 Code (Section 531 new Code), which provided for the special surtax of from 27.5% to 38.5% on earnings retained by a corporate taxpayer beyond the reasonable needs of the corporation. The case involved a corporation that had a very good earnings record and had consistently paid out an average of 50% of the earnings by way of dividends prior to 1946. In 1946, the corporation showed net profits after taxes of $170,000. The factual situation in the case showed that in 1946 two majority stockholders wanted to sell the business at a price they were unable to obtain on the open market. These two stockholders owned 80% of the stock while a third owned 20%. The 20% stockholder came up with the plan to have the corporation buy the 80% stock using $300,000 of corporate working capital and $500,000 of borrowings to swing the deal. The $170,000 earnings in 1946 were accumulated for purposes of funding the purchase and no dividends were paid in that year.

The Commissioner argued that the corporation retained its earnings for purpose of saving taxes for its stockholders rather than the reasonable business needs of the corporation itself. The corporation argued that buying out retiring stockholders of a closely held firm was a standard business practice to prevent the stock from going to outsiders who might change the company's policies or even liquidate it.

Tax Court Holding

The Tax Court agreed with the Commissioner, saying: "Where a closely held corporation adopts some plan (even having as its purpose the satisfaction of an otherwise bona fide business need) which prevents the distribution of earnings and profits with the attendant result that the imposition of surtaxes in substantial amounts on its controlling stockholders is avoided in whole or in part . . ." the 102 surtax will be applied. The court held that the failure to pay the dividend in 1946 had nothing to do with the corporation's own operating needs and that the corporation's argument of business purpose in the arrangement would not be recognized. The court did refer to the fact that in some instances surplus can be built up to take out a minority interest but it refused to apply the principle where majority interests were involved.

It is interesting to note that this case was affirmed by the Seventh Circuit, 1/7/58, which upheld the Tax Court in its narrow view of corporate business purpose.

Conclusion

The significance of all these cases is that if there is a departure from the normal standard buy-and-sell arrangement and you have aspects of cross-purchase mixed with aspects of entity purchase, you involve yourself with tax dangers. In addition, if you have closely held stock or family-held stock, with possible attribution dangers, any arrangement might create tax dangers and, in such circumstances, it might be better to use the provisions of Section 303 to redeem stock for purposes of paying death taxes and expenses of administration rather than attempting to set up in advance a buy-and-sell agreement with possible attendant dividend-treatment dangers. Until the Tax Court becomes more realistic in its approach to corporate business purpose in these agreements or until Congress writes into the Code the attempts of the courts of appeal to keep the Tax Court in line, caution should prevail. Remember: a hybrid agreement that is neither all cross-purchase nor all entity is an invitation to tax disaster. ☆

Technical amendments bill passes House

THE TECHNICAL CHANGES ACT of 1957 (Mills Bill) has now passed the House. It now goes to the Senate where Finance Committee Chairman Byrd says he hopes the Senate will pass it during the current session.

The bill as passed by the House differs from that reported out of Committee last summer in four ways:

1. The bill as passed does not restore the premium payment test for including life insurance in taxable estates.

2. The bill as passed makes a change in the rule requiring a dealer in securities who makes a short sale while he has the identical security in his investment account to reduce the holding period of the capital asset. The new rule would be applicable only if he stayed short for more than 20 days.

3. A special rule is provided for executors changing from the cash to the accrual method of accounting.

4. An elective adjustment to March 1, 1913, value of depreciable property is allowed to taxpayers (mostly railroads) who switcher from retirement to straight-line depreciation.

Three bills have passed both the House and the Senate and have been sent to the President. They are:

1. Give the IRS power to require delinquent employers to deposit withholdings in special bank accounts.

2. Give a restricted stock option unexercised by an employee at his death a stepped-up basis for income tax.

3. Extend to all of 1954 the rule excluding rents from Personal Holding Company income when the shareholder-lessee of the property used it for business.

The House has also passed a bill extending the present formula for taxing life insurance companies for another year. ☆

New publications of specialized interest to tax men

SOME TAX MEN will be interested in recent publication of new materials of specialized nature:

•*Preliminary Report on Individual Income Tax Returns*, 1955, latest in the series *Statistics of Income* published by the IRS. 20c, order from Supt. of Documents, Washington 25, D. C.)

•Ditto, final report for 1954. (75c, Supt. Docs.)

•*Corporation Income Tax Returns*, statistics of income for the year 1954. A gold mine of figures revealing the number, kind profitability, and tax paid by American corporations. (226 pages, paper, 11.25, Supt. Docs.)

•Fiduciary Income Tax Returns, ditto for trusts, etc. (56 pages, paper, 40c—Supt. Docs.)

•*Financing Highways*, the proceedings of the Tax Institute's annual symposium a year ago. This is a scholarly work, heavily centered on public finance and policy matters. (217 pages, boards, The Tax Institute, Inc., Princeton, N. J., 1957, $5.)

•*Appraisal and Valuation Manual*, a new and authoratative manual published by the American Society of Appraisers. This is an entirely new book; it contains articles dealing with newly developing industries. (500 pages, $15. Order from American Society of Appraisers, 369 Lexington Avenue, New York 19.)

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA and RICHARD L. GREENE, LL.B.

Using stock warrants in corporate acquisitions and reorganizations

by **RICHARD D. HOBBET**

Stock warrants have taken on increased importance recently in connection with corporate acquisitions and reorganizations. Mr. Hobbet, Milwaukee, Wisconsin, lawyer, analyzes the tax aspects of the use of stock warrants in this area and suggests several methods of handling transactions involving such warrants or options.

During the past few years most of the many corporations acquiring the business and assets of others have done it in exchange for their voting stock, thus qualifying the transaction as a Section 368(a)(1)(C) reorganization. But suppose, as sometimes happens, the stockholders of the acquired corporation demand an opportunity to acquire a larger block of stock than the assets of their business will pay for. These sellers will want the acquiring corporation, which we will call Amoeba Co., to give, as part of the consideration, warrants or options to buy an additional amount of stock at the market value on the date of the exchange.

At first glance, it might be thought that this will not affect the tax-free character of the exchange as the options or warrants, carrying the right to subscribe for additional voting stock, should be considered the equivalent of "voting stock" within the meaning of Section 368(a)(1)(C). Section 368(a)(1)(C) provides that "In general . . . the term 'reorganization' means . . . the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded . . ." After all, if the stockholders of the acquired corporation—lets call it Algae Inc.—were to contribute additional capital to Algae Inc. so that additional cash could be included in the assets transferred to Amoeba Co., they could receive the desired stock of Amoeba Co. immediately and they would be in substantially the same position they would be in if they receive stock warrants which they subsequently exercised.

However, since the warrants do not give the holders any of the rights of stockholders and the contractual rights are of value to the holders, the Supreme Court has held them to constitute other property. This was one of the holdings in *Southwest Consolidated Co.*,[1] where the Supreme Court, in considering the "solely for voting stock" requirement of an early statute, held that stock warrants did not constitute "voting stock." The Commissioner has adopted this same position in two brief sentences contained in his Regulations Section 1.351-1(a)(1) and 1.354-1(e).

Thus, in setting up a reorganization plan you may occasionally be confronted with the problem of how to give Algae Inc. or its stockholders the stock options or warrants which they want and still preserve the tax-free character of the exchange.

In some instances, Section 368(a)(2)(B) may provide an easy solution, for it has alleviated the strict requirement of "solely voting stock" to permit "other property" to be used in acquiring less than 20% in value of Algae Inc.'s assets.[2] This exception will not be available often because it considers the assumption of liabilities to be "other property." However, if you can keep the assumed liabilities plus the value of the warrants below 20% of the total consideration you will be able to qualify the exchange as a tax-free reorganization without difficulty.

A knottier problem is presented when the assumed liabilities leave no room for "other property." For example, Algae Inc. has assets worth $1,000,000 subject to liabilities of $250,000. It is to receive 7,500 shares of stock of Amoeba Co. and wants the right to purchase an additional 2,500 shares within one year from the closing at a price of $100 per share, the current value of the shares.

If transferable warrants for the 2,500 shares are given as additional consideration for the assets of Algae Inc. the exchange will clearly run afoul of *Consolidated Corp.* Worth considering is the use of nontransferable warrants exercisable only by Algae Inc. In this way neither Algae Inc. nor its stockholders would be in a position to realize cash from the warrants without first purchasing the shares which they represent. It seems difficult to conclude, in such case, that Algae Inc. has received "other property' in exchange for its assets. It has received nothing that can be sold, transferred or otherwise realized upon at the date of the exchange. Although it has received some benefit (its rights to increase its stock holdings), this benefit can only be realized by first transferring additional assets for voting stock. Thus, the reasons which prompted the Supreme Court to consider stock warrants as "other property" in the *Southwest* case do not appear to be present in this situation. Furthermore, the fact that the warrants are not assignable would probably furnish a way of distinguishing the *Southwest* case which apparently dealt with negotiable long-term warrants.

An even stronger case could be made for distinguishing the *Southwest* case if, instead of warrants exerciseable at a definite price, nontransferable options to purchase at the market value on the date of exercise were given as a part of

the exchange. In this situation, Algae Inc. would have no possibility of realizing any gain from its rights to acquire stock of Amoeba Co. If the value of the stock increased, the option price would also increase. Thus, whenever Algae Inc. exercised its rights, it would pay full value for the stock and could obtain a profit from a subsequent sale only if the value of the stock should increase after its purchase. Algae Inc., upon exercising the option, would be taking all the risks taken by an investor buying stock on the open market, and therefore, the option should not be given significance as property other than voting stock given in exchange for the assets of Algae Inc. In fact, the giving of the option would not even have to be considered as a part of the reorganization, but could be considered as a separate transaction if the option was extended directly to Algae Inc.'s stockholders.[3]

Another possible variation in the method of handling the desired transaction would be to transfer the additional stock to Algae Inc. as part of the initial exchange. This additional stock would be placed in escrow to be returned to Amoeba Co. upon certain conditions. One method might be for Algae Inc. to borrow enough cash to pay the agreed consideration for the additional stock and the contract of reorganization could provide that if it was not repaid within a specified period, making it necessary for Amoeba Co. to assume the liability, the escrowed stock would be transferred back to Amoeba Co. Or perhaps, the condition for the release of the escrowed stock to Algae Inc. might simply be the transfer of additional consideration of cash within the same specified period. By this method the tax adviser would attempt to spread the consummation of the plan of reorganization over a period of time. After this period, the *net effect* of the exchange, whether the escrowed stock was released to Algae Inc. or returned to Amoeba Co., would be no different than one involving a straight exchange of assets for stock under Section 368(a)(1)(C).

It may be said that this latter suggestion sounds very much like a "tax gimmick,' being a roundabout method of achieving a result, which, if obtained by a direct method, would have resulted in a taxable exchange. This is admitted and, therefore, is not recommended without misgivings and should be avoided if possible. The only reason a chance of success could be predicted for it is the unrealistic nature of the restriction which the Supreme Court imposed on reorganizations by its decision in *Southwest Consolidated Corp.* Perhaps the most graceful way out for the Court will be to distinguish that decision on narrow factual grounds, eventually prompting Congress to eliminate the distinction by legislation. Thus, in this instance, a "tax gimmick" could possibly be successful in providing the grounds for such a distinction.

Of course, we may still hope that Congress by statute, or the Service, by regulation, will take the initiative and permit warrants to be given in reorganizations without affecting their otherwise tax-free character. In order to prevent abuses by using warrants at less than market value as the equivalent of cash, it should be provided that warrants or options exercisable only at market value (either at the date of issue or exercise) will not be considered other property. Making this rule specific would obviate a sometimes troublesome problem for the tax adviser without creating any new opportunities for tax avoidance. ☆

[1] 315 U.S. 194 (1942).

[2] Section 368(a)(2)(B) provides "Additional consideration in certain paragraph (1)(C) cases: If (i) one corporation acquires substantially all of the properties of another corporation, (ii) the acquisition would qualify under paragraph (1)(C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and (iii) the acquiring corporation acquires, solely for voting stock described in paragraph (1)(C), property of the other corporation having a fair market value which is at least 80% of the fair market value of all of the property of the other corporation, then such acquisition shall (subject to subparagraph (A) of this paragraph) be treated as qualifying under paragraph (1)(C). Solely for the purpose of determining whether clause (iii) of the preceding sentence applies, the amount of any liability assumed by the acquiring corporation, and the amount of any liability to which any property acquired by the acquiring corporation is subject, shall be treated as money paid for the property."

[3] See, e.g., *National Bellas Hess*, 220 F. 2d 415 (7th Cir. 1955).

Flaws in thin incorporation and stock attribution rules analyzed

STUDY OF the report on Subchapter C by the Practitioners Group has suggested to your editors that this analysis of ambiguities and inequities in the present law, regulations doubtfully supported, and the other matters will be helpful to tax men struggling to apply the Code. The recommendations of this group of eminent practitioners (see box) acting as advisors to the Mills subcommittee (technically the Subcommittee on Internal Revenue Taxation of the Committee on Ways and Means) for change are equally important to anyone who must advise clients on proposed actions under Subchapter C. Since most corporate planning is intended to determine corporate structure for many years ahead, few actions can be conscientiously recommended without consideration of possible future changes in the law—and the scholarly reputation of this practitioner group and the legislative power of its organizers promises serious attention to its proposals. Over the next few months we plan to report these proposals to you in these columns and take note of the attention they receive in Congress.

Like most practitioners who study this problem, the members of the advisory group proposes that debts to stockholders be recognized if the obligations have certain specified provisions, characteristic of debt, up to an amount limited by its relation to equity. At 6 JTAX 262, we reported the suggestion of the ABA Tax Section that debt be recognized if it is incurred for consideration, is not subordinated, has a fixed maturity date, payment is not dependent on earnings and the debt does not exceed ten times the book value of the stock. You will note that the Advisory proposal would allow only five times the value of stock and would use as the test not book value, but fair value. This is what the advisory group said:

"Under the existing administrative practice and court decisions, there is considerable uncertainty as to the proper income tax treatment of corporate debt obligations held by shareholders. The problem has been fruitful of much controversy and litigation during recent years. The uncertainty is illustrated by the recent decision of the Court of Appeals for the Second Circuit in *Gilbert et al.* v. *Com.*, 9/26/57, which involved advances to a corporation by its two stockholders. The court remanded the case to the Tax Court because of its failure to specify the standards it followed in concluding that the advances constituted contributions to capital rather than loans. Yet, as indicated by the separate opinions of each of the three judges, the appellate court could

not agree upon what standards Congress intended should be followed in determining the status of the advances for tax purposes.

"The advisory group recommends that consideration be given to the desirability of providing greater certainty in this area as a guide to taxpayers, administrators, and courts in ordinary cases. The proposed Section 317(c) is designed to apply only to the clearest types of obligations, and is intended to be without prejudice to the determination of the status of other alleged obligations not coming within its strict requirements. It is believed that such a provision would be of special benefit to small incorporated businesses and the owners thereof; for, unlike publicly held corporations, small closely held corporate businesses must often look to their stockholders as the only source of borrowed money."

Proposed new rule

Exactly what debt would be recognized is shown by the text of the proposed new section of the Code:

"For purposes of this subtitle, indebtedness of a corporation shall include in all events (but shall not be limited to) any unconditional obligation of a corporation to pay on demand or on or before a specified and not unreasonably distant date a sum certain in money incurred upon a distribution to shareholders or for an adequate consideration in money or money's worth and under circumstances which do not negative any reasonable expectation of payment, if—

"1. The obligation is not by its terms subordinated to the claims of trade creditors generally, and

"2. By the terms of the obligation, payment, if any, for the use of the principal amount is not excessive, is not dependent upon the earnings of the corporation, and is unconditionally due not later than the maturity date of the principal amount, and

"3. The obligation does not by its terms entitle the obligee to vote upon the election of directors of the corporation, and

"4. In case the obligation is initially held or guaranteed by a shareholder of the corporation, immediately after the obligation is created the principal amount of all obligations of the corporation held or guaranteed by its shareholders does not exceed by more than five-to-one the fair value of the outstanding stock of the corporation or the total of the capital and surplus paid-in with respect thereto, whichever is greater."

Advisory Group

MEMBERSHIP of the Advisory Group appointed by the Mills Subcommittee consists of the following well-known tax practitioners:

Norris Darrell, Chairman
C. Rudolf Peterson, Vice Chairman
Edwin S. Cohen
Marvin K. Collie
Kenneth W. Gemmill
Samuel J. Lanahan
Leonard L. Silverstein

Threat in buy-sell agreement

For some time now tax men have been warning of the threat of an inescapable dividend tax that might make a pre-1954 stock purchase agreement a financial disaster on the death of a stockholder. If the corporation were obligated to buy stock from the estate of the decedent and if other stockholders were interested in the estate, then under the attribution rules there would be, in many family corporations, an automatic and inescapable dividend in the redemption. (There is an extended discussion of the problem at 4 JTAX 322.) The advisory group considered recommending a special rule to cover this situation, but decided it was not needed, in view of their general recommendation that the Code be amended to provide specifically that in determining whether a redemption is essentially equivalent to a dividend the attribution rules need not be automatically applied. This is what the group said about the redemption problem:

"The attention of the advisory group was called to cases involving redemption from estates of deceased shareholders made pursuant to contracts between the decendent and the corporation. Such a redemption does not qualify under the 1954 Code for capital gain treatment under Sections 302(b)(2) or (3) even though all stock owned by the estate is redeemed if the beneficiaries of the estate own a substantial number of shares outright or by attribution from other sources."

Section 302 provides that "(a) If a corporation redeems its stock . . . and if paragraph (1), (2), (3) or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

"(b) Redemptions treated as exchanges: (1) Redemptions not equivalent to dividends,—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend. (2) Substantially disproportionate redemption of stock.—(A) In general, subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder. . . . (3) Termination of a shareholder's interest.—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder. (4) Stock issued by railroad corporations in certain reorganizations. . . . (5) Application of paragraphs.—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3) or (4) shall not be taken into account. . . ."

Turning now to the proposed revisions the group would make, they find no necessity for a special rule. They say:

"The redemption may qualify under Section 302(b)(1) as a distribution not essentially equivalent to a dividend, particularly in view of the recommended amendment to Section 302(b)(5) of present law providing that the attribution rules of Section 318 shall not be applicable to Section 302(b)(1) but that the relationships described therein may be taken into account along with all other facts and circumstances. The advisory group feels that in view of Section 302(b)(5) of present law, this situation can be adequately dealt with in the light of the special circumstances of each case and no special statutory rule is required."

Equivalent to a dividend rule

This is what the group has to say about changing the rule allowing capital gain treatment for redemption not substantially equivalent to a dividend:

"The advisory group recommends that Section 302 be amended to provide specifically that, in determining whether a stock redemption is essentially equivalent to a dividend under Section 302(b)(1), the constructive ownership rules of Section 318 shall not be applicable, but the relationships described therein may be taken into account along with all other facts and circumstances. For ex-

ample, where a father and son own large interests in a corporation but have become estranged so that the son desires to buy the father out of the business by means of a stock redemption, it may be that the redemption will not qualify under Section 302(b)(2) or (b)(3) because the father has other stock attributed to him. Where the father is one of the beneficiaries of a trust owning a small amount of stock, the father will be unable to terminate completely his interest in the corporation if the trustee is unwilling to have the trust's stock redeemed. As a result, the father cannot comply with the requirements of Section 302(c)(2), and the sons's stock will be attributed to the father despite the fact that all of the stock actually owned by the father has been redeemed. It is believed that this amendment reflects the intent of the present statute, which now states that the fact that the redemption does not qualify under (b)(2) or (b)(3) shall not be taken into account in making the determination under (b)(1)." ☆

Tax exchanges for marketable securities?

YES, SAYS Jerome R. Hellerstein, New York attorney, in an article in the December, 1957, *Harvard Law Review*. This is Mr. Hellerstein's proposal: "The Code should be modified to eliminate the provision for nonrecognition of gain or loss in reorganization exchanges in which the exchanging stockholders receive stock traded on an exchange or in the over-the-counter market if an adequate market exists for the sale of stock received."

He points out that, as the Code is now, the tax law provides positive encouragement to mergers through the tax advantages granted to the stockholders and security holders of the corporation being acquired.

"The profitable going company," he says, "is in a position to effect expansion through merger with highly advantageous tax results to itself and the stockholders of the company being acquired. If we are dealing with the acquisition of a comparatively small company or its business by a large company, and particularly by a company whose stock is traded on an established exchange or over the counter, the law offers virtually the ideal tax solution to the stockholders and security holders of the smaller company. They receive, without tax, liquid assets in the form of stock readily saleable on the market at known values. This stock can be held if desired, or sold off in pieces or as a whole when the stockholder desires—then incurring a tax at only capital gain rates. In this way, cash funds can be realized inexpensively through partial sales, as desired by the holder, a feat difficult to accomplish or undesirable for business reasons in a small or closely held company; estate tax valuation and liquidity problems are typically eliminated; and no tax is paid until there is a sale or other disposition of the stock of the acquiring company."

Purpose of tax-free provisions

Mr. Hellerstein reviews the legislative history of the tax-free exchange provisions, which shows the purpose to have been removing tax from purely paper transactions. "However," he continues, "many of the exchanges permitted by the reorganization provisions are changes 'merely in form' only as judged by highly artificial standards; that stockholders and security holders again and again obtain interests in the merged companies which cannot properly be regarded, from a realistic point of view, as either 'continuing their former interest' or as being an interest in a continuing enterprise, and that judged by business standards—by the yardsticks of the marketplace—exchanges in many tax-free mergers involve substantial changes of economic position and holdings warranting taxation to the exchanging stockholders and security holders."

After examining some of the more widely publicized mergers of recent years, Mr. Hellerstein concludes, "The current deep concern in many quarters with the dangers to our economy of the increasing concentration of industry in the larger corporations and the disappearance of smaller business—a problem which admittedly should be dealt with frontally and not primarily through taxation—accentuates the need to take a new good look at the reorganization provisions and related Code sections." ☆

New corporate decisions this month

Tax Court erred in finding date corporate existence ended. The taxable year of taxpayer, a corporation, commenced regularly on 3/1. It filed its fiscal income tax return for the fiscal period 3/1/49 to 10/31/49 an 2/20/50. The Commissioner assessed a penalty because this return was not filed by January 15 (2½ months after 10/31). Taxpayer argued that because a directors' meeting was held later, the final year ended later than October 31 and the February 20 return was timely. The Tax Court found that the corporation ceased to do business and had disposed of all its assets on 10/31/49, and upheld the penalty. This court remands. The mere disposition of assets does not in itself determine the end of taxpayer's existence as a taxable entity. This determination must be made from all the facts of corporate activity, etc. On remand, the Tax Court is to clarify the stipulation of facts and hear other evidence. *Berry*, CA-9, 12/10/57.

Distribution on 5% "preferred stock" a dividend and not interest. A sale of the entire issue of "5% cumulative preferred stock" by a telephone company is held to represent equity investment capital so that the "dividends" paid by the company were in fact dividends and not interest on borrowed capital, and the expenses incident to such sale were capital expenditures rather than amortizable deductions. The court noted that the issue was called "preferred stock" and so treated by both buyer and seller on their respective books; dividends were payable out of surplus; and the holder possessed no rights of a creditor in the event of default of dividend payments. Evidence was also presented that the state regulatory commission would not have permitted taxpayer to borrow additional funds by issuing long-term debenture bonds. *Lee Telephone Co.*, TCM 1957-230.

Advances to corporate newspaper venture nonbusiness bad debts. Three brothers in the cattle business formed a corporation to start a newspaper. They advanced $84,300 to keep the newspaper going, but it was a losing proposition from start to finish. The brothers contended that the corporation never came into existence because corporate formalities of annual meetings, etc. were not observed, and that all the expenses and losses were their own. The Tax Court found the paper was published by a valid corporation which was a separate

taxable entity. The advances were held to be nonbusiness bad debts. As the debts were only partially worthless in the taxable year, no deductions were allowed. This court affirms. *Skarda*, CA-10, 11/30/57.

No continuity of interest; transfer not reorganization; gain is capital not ordinary. Taxpayers, who were holders of less than one third of the outstanding shares of a company, exchanged their stock for bonds and notes of a second corporation pursuant to a plan whereby their old company was merged into the other. The Commissioner contended the merger was a statutory reorganization and that the notes received were property not received tax-free and had the effect of a dividend. Consequently he determined the notes were a distribution of earnings and profits taxable as a dividend. However, the court finds the exchange was a sale rather than a reorganization; it was not a statutory merger, because the stockholders of the selling corporation did not continue their proprietary interests in the purchasing corporation. Accordingly, the entire gain realized by them was taxable as long-term capital gain. *Truschel*, 29 TC No. 47.

No dividend in transfer of subsidiary stock in trust for stockholders. A national bank owned all the stock of a subsidiary which performed functions which the bank itself was not permitted to perform. To meet the requirements of the Comptroller of the Currency that it divest itself of the subsidiary, the bank transferred the subsidiary stock to its directors as trustees, with the beneficial interest in the bank stockholders. Since this beneficial interest could not be transferred separately, and was automatically transferred with the transfer of the bank stock, the court holds the bank stockholders did not receive a dividend distribution upon transfer by the bank of the subsidiary stock to the trustees. *Wilkinson*, 29 TC No. 45.

Rights to buy sub's. stock will be dividend to parent's stockholders. Hudson's Bay Oil and Gas Company, wholly owned 75% by Continental Oil and 25% by Hudson Bay Company (both parents being publicly held) proposes to issue rights to buy its stock directly to the stockholders of its parents. The IRS rules that the rights will be treated as dividends from the parents at fair market value of the rights. *Spec. Rul.* 12/2/57.

Diverted funds taxed to controlling stockholder as dividends. Checks representing income to taxpayer-corporation and diverted by a controlling stockholder to his own accounts are held taxable as income to the corporation and as a constructive dividend to the stockholder. Excessive rental paid by the corporation for property held in the name of the stockholder's son as nominal owner, and salaries paid to the wife and son who performed no substantial services, are also held to be informal dividends to the stockholder. *Jolly's Motor Livery Co.*, TCM 1957-231.

Trust holding assets of dissolved corporation not taxable as a corporation. A trust created upon the dissolution of a corporation and for the purpose of holding certain licenses, the assets of the corporation, for the benefit of its shareholders, will not be taxed as a corporation because, under the trust arrangements, the functions which the trustee may perform without unanimous approval of the grantor-beneficiaries are wholly ministerial in nature, and approval by all the beneficiaries is required before any major management function may be exercised by the trustee. Lacking power to act, the trust differs so substantially from a corporation it can't be taxed as one. *Rev. Rul.* 57-607.

TAXABLE AND TAX-FREE EXCHANGES

Negotiable certificates of contingent interests are "other property" in merger. A merger of two corporations had been proposed; however, because the disappearing company had outstanding Federal tax controversies, it was planned to withhold some of the shares of the surviving corporation to which its stockholders would be entitled and instead to issue to them a negotiable certificate of beneficial interest entitling them to their share of the withheld stock upon settlement of the litigation, together with cash representing the amount of dividends that would have been paid in the meantime. The IRS rules the certificates are to be treated as "other property." These certificates are not stock and therefore cannot be received tax-free. Gain will be recognized on the exchange, but not in excess of the value of the certificates. The portion of this gain not in excess of the earnings of the disappearing corporation will be dividend income; the rest, capital gain. *Rev. Rul.* 57-586.

Interposition of parent corporation does not destroy "continuity of interest." Properties of a realty company were transferred in a receivership proceeding pursuant to court order to a new corporation and to two of its wholly-owned subsidiaries. The three new corporations were allowed to claim as their basis for depreciation the basis of their predecessor corporation, since all the transfers are held to qualify as a tax-free reorganization. The court states that it makes no difference on the continuity-of-interest question whether the business is carried forward by the old stockholders (in this case bondholders) by a direct stock ownership in themselves, or stock ownership in a parent and wholly-owned subsidiaries. In either case their interest is carried forward as the continuing business in different corporate form. *Consolidated Office Buildings Co.*, 29 TC No. 55.

Loss not recognized on sale and leaseback; it was a nontaxable exchange. Taxpayer, the large Boston department store (a wholly owned subsidiary of publicly held Allied Stores) sold its land and buildings at fair market value ($2,300,000) at a loss and simultaneously leased the property for a term of 30 years at a fair rent with an option to renew the lease for a like term. The court holds the loss on sale not deductible on the ground that the sale and leaseback involved an exchange of properties of "like kind" within the intent of 1939 Code Section 112. The Regulations providing that a lease of 30 or more years and real estate are property of like kind have been approved by the courts in other cases which are controlling here. *Jordan Marsh Co.*, TCM 1957-237.

Assets acquired through stock purchase have basis equal to stock cost. Taxpayer wanted to obtain the assets of A corporation, and therefore purchased its stock. He then contributed the stock to B Corporation and merged A into B. The court finds that the purchase of stock and the merger were component steps of an integrated plan to purchase the assets of A and contribute them to B. Following *Kimbell-Diamond* (187

F.2d 78, *cert. den.* 342 U.S. 847), it finds that the basis of the assets in B's hands for depreciation is the amount which taxpayer paid for the stock. [The 1954 Code specifically provides that a parent on liquidating certain recently acquired subsidiaries takes the assets with a basis equal to its cost for the subsidiary stock. —*Ed.*] *G. Haiss Mfg. Co.*, TCM 1957-241.

Jury allows revocation of election of "one-month" liquidation. While the stated facts are not clear, apparently taxpayer elected to treat the gain on liquidation of his corporation under the "one-month" rule of Section 333. This election was unfavorable because the corporate assets were much greater than the bookkeeper had informed him of, with the result that more of the gain would be taxed as ordinary income. A jury finds that the election was made undera mistake of fact and permits the taxpayer to revoke it. The jury also finds the corporation had no goodwill at time of liquidation. *Cockrell*, DC Tex., 11/5/57.

OTHER DECISIONS

No gain on liquidation distribution of installment obligations. A corporation engaged in the business of selling cheap furniture to very poor people on the installment basis realized no taxable income upon a distribution in liquidation of installment obligations in the face amount of $62,000. The court found that the fair market value of the obligations at the time of liquidation was not in excess of their cost or tax basis of $27,500. The corporation was therefore not subject to a deficiency for which its stockholders could be held liable as transferees. *Sanders*, TCM 1957-229.

PHC can deduct EPT in year controversy is settled. This is another in the series of cases on the meaning of "paid or accrued" in the personal holding company tax. Taxpayer here in computing its 1949 personal holding company tax, deducted in 1949 an excess profits tax deficiency for 1945 paid then, on the ground that it was an accrual basis taxpayer and when its controversy over the correct 1945 tax was settled it was accruable and deductible. This court, reversing the Tax Court, agrees that "paid or accrued" here has the same meaning as elsewhere in the Code and allows the deduction. The First Circuit thus lines up with the Seventh in opposition to other circuits, which allow only the tax applicable for the year the personal holding company tax is being computed. *Mills Incorporated*, CA-1, 12/4/57.

Cash basis personal holding company can deduct taxes applicable to prior years. In computing its personal holding company tax for 1950, the Tax Court held that taxpayer, a cash basis corporation, could deduct the portion of its 1949 income tax liability which was paid in 1950. The penalty surtax, it said, applies to the income remaining after dividend disbursements and tax payments applicable to the taxable year. This court reverses. It adheres to its holding in *De Soto*, 235 F.2d 409, that the Code language here of paid or accrued is to be interpreted in the same way as in other sections, i.e., in accordance with taxpayer's accounting method. *Patten Fine Papers, Inc.*, CA-7, 11/26/57.

Corporation forced to sell housing after completion of construction not collapsible. A corporation which completed construction of housing under the Whemy housing program prior to the Housing Act of 1956, and was required to sell such property to the military authorities pursuant to, and solely because of such act, will not be considered as a collapsible corporation, even though due to the sale it might meet some of the tests of collapsibility. When sale is forced, there will not ordinarily be the requisite in forming or using the corporation to support its treatment as collapsible. *Rev. Rul.* 57-575.

Contract to purchase inventory not "collapsible corporation" asset. Taxpayers as partners had a contract to purchase 3,500 trailers. They assigned this contract to a corporation. After the corporation had sold 1,800 trailers and was to receive 1,600 more under the contract, holding 100 in inventory, taxpayers sold their stock. The Commissioner contends the gain is ordinary income under the collapsible corporation provisions. The taxpayers invoke two limitations on the applicability of these provisions, both of which the court upholds. (1) Since the contract to purchase is not itself inventory, less than 70% of the gain is attributable to the sale of assets of the class described in Section 117(m) of the 1939 Code [Section 341 of the 1954 Code.—*Ed.*] (2) Income realized on the 1,800 trailers sold was 51% of the total anticipated income; the corporation thus realized a "substantial" part of the income from the property, and was not within the definition of a collapsible corporation. *Levenson*, DC Ala., 12/11/57.

Can't consolidate purchased losses of "shell" subsidiary [*Certiorari denied*]. At issue here: about $200,000 tax deduction effected by the taxpayer, American Pipe and Steel Corp., by filing consolidated returns and using the "built-in" loss of a real estate company it purchased. Taxpayer was in the steel fabricating business. In 1943 it paid $4,300 for all the stock of a real estate corporation. After the acquisition, the subsidiary sold for about $18,000 its undeveloped real property at losses of about $400,000, which were reflected in the consolidated returns. The Commissioner determined that the principal purpose motivating American Pipe's acquisition of the real estate corporation was the evasion or avoidance of taxes through obtaining thereby tax benefits not otherwise available and pursuant to Section 129 of the 1939 Code denied the right to file consolidated returns. As taxpayer failed to sustain its burden of proof, the Commissioner's determination was sustained by the Ninth Circuit. *American Pipe & Steel Corp., cert. den.*, 12/16/57.

Pre-affiliation loss of parent no carryover against post-affiliation gain of subsidiary. Taxpayer's year ended March 31. On March 2 it acquired all the stock of a profit-making company and filed a consolidated return with it. The district court upheld the Regulation denying the deduction of taxpayer-parent's loss for the 11 pre-affiliation months against the subsidiary's income for the one-month affiliation. Nor can the loss be used as a carryforward in later years. This court affirms. *Olivier Company*, CA-5, 12/23/57.

Election to take foreign taxes as credit binds all members of affiliated group. Some members of an affiliated group which file a consolidated return cannot elect to claim a credit for foreign taxes, if other members take the foreign tax payments as deductions in computing the consolidated net income. The election to claim the foreign tax credit is required to be made with respect to all the affiliates. *Rev. Rul.* 57-601.

TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

Ways & Means Committee considers change in Subchapter K structure, basis rules

THE PARTNERSHIP provisions of the tax law would be vastly easier for most people to use if they were rearranged to put together the rules affecting most partnerships, says the Practitioners Advisory Group (see box page 167). In passing on to the Ways & Means Committee their recommendation that Subchapter K be rearranged to do this, the group also makes many other recommendations for improvement in partnership taxation.

The group's investigation of Subchapter K is turning up a gold mine of information of practical use to practitioners. In the course of advising Representative Mills' Subcommittee on Internal Revenue Taxation, these experts have shed quite a lot of light on how partnership taxation works. In pointing out flaws in the law they explain how to work with these same provisions.

Here we report the group's ideas on rearranging Subchapter K, basis problems, and the conduit principle. Next month we will bring you reports on other changes sought.

Rules for simple partnerships

"The present partnership provisions," the group says, "have been criticized on the grounds that they are too complicated and that the taxpayer who is a member of the average simple partnership cannot be expected to understand many of the preesnt provisions. It is believed that some of the difficulty in this respect stems from the fact that, in actual practice, the operation of partnerships can vary significantly. Most of the difficulty probably arises from the fact that a partnership is viewed by some as an entity separate and apart from the partners while to others the partnership is viewed as an aggregation of the partners, each acting in his own individual capacity. The partnership provisions of present law take both this "entity" and this "aggregate" concept into account. The "entity" concept is most frequently applied by the statute, since it ordinarily operates more simply than does the "aggregate" concept. Usually elections are available, however, making it possible for the partners or partnership to follow the aggregate concept if they care to do so. These elections are necessary if the tax laws are not to freeze partnerships into a rigid mold, but, nevertheless, they are a complicating factor. Moreover, there are other relatively complicated partnership provisions, designed to prevent tax avoidance or undue hardship, which are unlikely to apply in the type of transaction which the simple partnership or partner is likely to engage.

"Your advisory group has concluded that, in actual practice, a substantial simplification can be achieved for the average simple partnership by grouping in one part the provisions likely to be applicable to these partnerships and by grouping in another part the various elections and other technical provisions of a narrower application."

The advisory group recommends a rearrangement of the Code under which the existing partnership provisions would be grouped into five parts: "Part I deals with the rules generally applicable to partners and partnerships and contains the provisions with which a simple partnership is most likely to come in contact. For the most part, these represent the general rules contained in the forepart of the existing sections. Part II contains the so-called collapsible partnership provisions which may result in ordinary income treatment where an interest is sold or exchanged, or in the case of certain types of distributions. These provisions, although unlikely to apply in the case of simple partnership, probably will, nevertheless, have a somewhat wider application than the special rules contained in part III. Part III contains the various elections and special rules which, for the most part, apply only in the case of the more complicated types of partnership arrangements. Part IV in the proposed rearrangement contains the definitions, and part V the effective dates for the subchapter."

Conduit principle

Section 702 of the Code as it now stands is a pretty thorough-going legislation of the "conduit principle." Section 702(a) provides that the partner's return is to show separately his share of seven different kinds of income or deduction, adds (8) that the Secretary may require other items to be shown separately. Section 702(b) then states the rule that "the character of any item of income, gain, loss, deduction or credit included in a partner's distributive share under paragraphs (1) through (8) of subsection (a) shall be determined as if such items were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership."

The advisory group points out that this language in 702(b) does not necessarily mean that the tax treatment of specific items to all partners will be the same. The report says that "the advisory group would like to emphasize that Section 702(b) provides that the income is to be determined as if any item were realized directly by the partner from the source from which realized by the partnership or incurred in the same manner by the partner as incurred by the partnership. Thus, the sale of a property by a partnership might result in ordinary income to a partner who is a real estate dealer and capital gain to other partners. However, just as it is possible for a real estate dealer who is a sole proprietor to have a segregated investment account (sales from which result in capital gain) so also is it possible that a partnership interest represents an investment account, sales from which will give rise to capital gain rather than ordinary income. This would be a fact question which would have to be separately determined in each case in the same manner as where the property in question were held directly by an individual.

"Although the character of the income items is to be determined at the partner

level, account must be taken of the fact that the partnership is acting for the partners and thus that they are engaged in whatever business the partnership is. Thus, where there is a sale of property being used in a trade or business at the level of the partnership (e.g., either for sale to customers or depreciable property) the partnership character of any gain from such a sale would be attributed to the partners since they individually would be considered as engaged in the partnership business."

Rule for basis of interest

Determining the basis of a partner's interest can be an extremely difficult task if the historical method is used—finding the partner's basis for property originally invested and making proper adjustment for all subsequent transactions can be almost impossible. Unfortunately, this historical method is the general rule. The advisory group of practitioners would make this the alternative method and generally compute partners' basis by reference to the basis of the assets of the partnership. This is how they see the problem:

"Section 705 provides two rules, a general rule and an alternative rule, for purposes of determining the basis of a partner's interest where this basis may be needed in computing the gain on the sale of an interest, in the case of certain distributions, etc. The general rule requires a partner to determine the adjusted basis of his interest by taking the basis of the property originally contributed to the partnership, or the basis of the interest at the time of purchase, and then making certain adjustments in this basis. In general, the basis is to be increased for a partner's distributive share of the income of the partnership, whether or not it has been taxable income, and decreased by the partnership basis of assets distributed to him, and by the partner's distributive share of losses of the partnership. The alternative rule provides that the Secretary or his delegate may prescribe the conditions under which, instead of making the detailed adjustments described above, the adjusted basis of a partner's interest may be determined by reference to what his proportionate share of the adjusted basis of partnership property would be if the partnership were to be terminated at that time. The adjustments to the basis of a partner's interest, whether made under the general rule or alternative rule, occur throughout the year on the basis of all of the partnership transactions up to the date the basis must be determined.

Alternative rule simpler

"The partnership in any case frequently has to determine the adjusted basis of partnership property, with the result that the alternative rule, where the Secretary permits its use, is much simpler to apply than the general rule. Moreover, in the case of the simple partnership, where the contributions and distributions have been in money and there have been few if any transfers of partnership interests, the basis for a partner's interest reached under either rule is likely to be substantially the same.

"In view of the greater simplicity of the alternative rule your advisory group is recommending that this so-called alternative rule, with modifications, be made the general or standard rule, and that the general rule be made the alternative rule. Thus, under the proposal the simpler rule for determining basis will apply unless the partnership elects otherwise. For this simpler rule to apply, however, it will be necessary to limit its application to those cases where the contributions, transfers, and distributions which have occurred will not result in any substantial difference in the basis for a partner's interest, computed in this manner and computed under the new alternative rule. However, if there is a substantial difference, under the proposal partners will still be permitted to use the simpler method of computing the basis for their interests if they are willing to make whatever adjustments are necessary to eliminate any substantial difference in basis computed under the two methods. The restriction on the use of the simpler rule is to apply, however, only if the Secretary or his delegate, or one or more of the partners, can establish that there would be a substantial difference as a result of prior contributions, transfers, or distributions if the more complicated rule had applied. In other words, the Secretary or his delegate, or the partner, whoever is contending that the more complex rule should be followed by the partnership, has the affirmative burden of proof."

Advisory Group

Membership of the advisory group appointed by the Subcommittee on Internal Revenue Taxation (Wilbur Mills was the chairman) consists of the following well-known practitioners:

Arthur B. Willis, Chairman
Harry Janin, Vice Chairman
Mark H. Johnson
Paul Little
Donald McDonald
Herbert B. Story
Laurens Williams

Abner Hughes (resigned in May, 1957)

Three new texts on partnership taxation

WE HAVE recently received three texts on the taxation of partnerships. The first to arrive was The Practicing Law Institute *Monograph on Partnership Law*,*—one of the series on Fundamentals of Federal Taxation. This is written by Alan J. B. Aronsohn, a member of the New York Bar. It is 106 pages long and does not purport to be an exhaustive study of the subject. It is the type of pamphlet that can be read in one or two sittings and will give the reader a birdseye view of the problems involved. We make it a habit to read through each of the monographs put out by the Practicing Law Institute simply as a refresher. This monograph is well done and we recommend it as reading for an evening or two by every tax practitioner.

Little's 1954 Code supplement

The next text to arrive was the supplement to Paul Little's *Federal Income Taxation of Partnerships*.* His original book came out in 1952 and was immediately acclaimed as the finest work on the subject. Two years later the statutory provisions relating to partnerships were completely changed by the 1954 Code. This supplement accomplishes two purposes. First, it brings up to date the subject matter under the 1939 Code. Second, It gives us the parallel Code references between the 1939 and the 1954 Codes, discusses the significant changes made by the 1954 Code, and sets forth, as to each Code provision, the effective date. An excellent appendix includes the sta-

*Monograph on Partnership Law, by Alan J. B. Aronsohn, Practicing Law Institute, New York, N. Y., 106 pages, $2.00. Supplement to Federal Income Taxation of Partnerships, by Paul Little, Little, Brown, Inc., Boston, Mass., 548 pages, $12.50. Handbook of Partnership Taxation, Arthur B. Willis, Prentice-Hall Inc., Englewood Cliffs, N. J., 585 pages, $15.00.

tutory provisions, committee reports, and Regulations under the 1954 Code.

Willis' new book

The last text to arrive was Arthur B. Willis' *Handbook of Partnership Taxation.** Mr. Willis has taken the law as it is under the 1954 Code. His book discusses the subject in a logical manner, starting with the general tax concepts of partnerships, and then going into forming the partnership, operating the partnership, selling or exchanging partnership interests, distributions, and death and retirement. Mr. Willis has a set of forms at the end of his book that should prove especially useful. Throughout the book are tax planning suggestions and analyses of the statutory provisions and the regulations.

In examining and comparing these three texts, we decided to analyze them first, from the standpoint of their usefulness and convenience, and second, from the standpoint of the thoroughness of their content. Aronsohn's book is useful primarily as a review of the whole field. There is a satisfactory table of contents, but there is no index. Many of the subjects are discussed rather briefly but in general all of the pitfalls are indicated. We would not recommend that anyone research a question of partnership law using Aronsohn's monograph alone.

Little

We regret to say that Little's book in its present form is one of the most inconvenient law texts we have ever seen. Subchapter K of the 1954 Code completely changed our whole concept of partnership taxation. Prior to 1954 the statutory provisions were meager. Mr. Little's original book was of necessity arranged from the standpoint of the pertinent case law. Many of the concepts injected by the 1954 Code had no counterpart under the 1939 Code, and his original arrangement is outdated.

The text matter of the original book is brought up to date by those changes affecting ony the law under the 1939 Code. The 1939 Code is of interest only to those few practitioners who have negotiations under way with the Service relating to returns filed for 1955 and prior years. From the standpoint of the average practitioner today, this part of his supplement is solely of historical interest. This division of material into the two Codes proves very confusing. On page 51 of his book he sets forth the provision of the 1954 Code which permits partners to agree among themselves as to the distributive share of each partner of separate items of income, gain, loss, deductions and credits. Then on page 55 he refers to a ruling under the 1939 Code in which the Commissioner refuses to approve the division of various items of income differently between partners depending on source. On page 53 there appears the statement that you can allocate capital gains to one partner and ordinary income to another. Then on page 63 there is a reference to a Revenue Ruling which indicates that you cannot allocate capital gains to one partner and ordinary income to another. This Revenue Ruling was issued in 1956 but there is no reference to the fact that the rule is different under the 1954 Code. The reader of this supplement must be careful to make sure that what he is reading relates to the 1954 Code if that is what he is concerned with. He has no way of knowing when reading the material in the original book or the addition thereto in the supplement whether such material is still applicable to the 1954 Code. As a practical matter, therefore, all of the material under the 1939 Code is wasted on anyone who has a problem under the 1954 Code.

The index and table of contents in Little's supplement are very inadequate. We wanted to find the discussion of the limitation on the deduction of partnership losses by a partner. We went through the table of contents and found nothing at first blush that would indicate such a discussion. We then looked up the words "loss," "partnership," "limitations," and "deductions," in the index. None of them referred us to a discussion of this problem. We finally found it under the heading "Deductible Item-Losses in General." In looking for other matters which have arisen under the 1945 Code we met similar difficulties.

Willis

Arthur B. Willis had the advantage of starting out fresh with the 1954 Code. The arrangement of his book is excellent and we were able to find every matter we were interested in simply from the table of contents. We presume that the index is adequate, bue we never had occasion to use it. The forms in the back of the book are excellent. The tax planning advice is good and we were much interested in his criticisms of the law and Regulations. Mr. Willis was lately chairman of the Patrnership Committee of the Section of Taxation of the American Bar Association and has served on the Mill's subcommittee dealing with partnerships. His knowledge of the background of our present law is extensive and he has put it to good use in this book.

Thoroughness of texts

Turning now from the question of usefulness and convenience to that of thoroughness of contents we must, of course, immediately eliminate Aronsohn's monograph from the discussion. It was not intended as a complete text on partnership law. The remaining two books are quite long, Willis' being 585 pages and Little's 548 pages. We did not plan to read each book from cover to cover, so as a test of the thoroughness of contents, we selected four fields of partnership taxation which we felt were particularly vexing. The first was the question of the limitation on deductibility on partnership losses. After we finally found where Little covered this item (Section 37.7) we were disappointed by his discussion, which was sketchy and required cross references to several other sections to get the entire picture. Willis discusses this question in an able manner, setting forth ways of avoiding the harshness of the rule, and giving some excellent pointers on controlling the year of deductibility of such losses.

We next examined both books for their discussion of the question of gain or loss on contribution of property to a partnership. Willis had an excellent and thorough discussion of this problem and spends a great deal of time on the problem which arises when a partner is given a capital interest for his services. Little makes the flat statement that there isr no gain or loss on a contribution to a partnership and has no discussion of the problem of receipt of a capital interest for services. It is possible that he discusses this question some place else other than in section 3.2, but we did not have the patience to look for it.

Next we thought we would check these two books for their discussion of the problems involved in the liquidation of

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a partner's interest in full. In Willis' book we found an excellent discussion of this matter. His tax planning advice was good, particularly with reference to timing the liquidating distributions. Little's table of contents referred us to section 8.9 which then referred us to section 8.1A. He gave the general rules on both liquidating distributions and current distributions with no discussion of the problems involved in timing these distributions.

Finally we checked the two texts for a discussion of the problems involved in the termination of a partnership. Willis had an excellent discussion of the problems arising from the sale of a partner's interest. But he does not have a very thorough or complete discussion of the problems arising when a partner goes back into business as a partner. Little has a very good discussion of the whole problem of termination of partnerships. His discussion of the problem when a partner goes into another partnership or sets up a business for himself with a new partner was excellent and pointed out many of the possibilities which we had not thought of.

Each performs different function

Each of these books, in our opinion, performs a separate and distinct function. Aronsohn's monograph is best suited for a quick thumbnail review of the entire problem of partnership law. On each of the four items of content referred to above, Aronsohn made a sufficient reference to the matter to alert the reader, but in no situation did he cover it nearly so thoroughly as the other two authors. We repeat, however, our recommendation that every practitioner could benefit from a complete reading of this monograph.

If you already own Little's original text, and have any volume of tax work under the 1939 Code still at hand, it would probably be worth your while to acquire the supplement. We would not recommend it for use under the 1954 Code, however, because of the difficulty of finding the pertinent sections and because the author has made no effort to show which decisions and rulings under the 1939 Code are still applicable under the 1954 Code.

Willis' book is at present the most useful and up-to-date text on the subject of taxation of partnerships. Any practitioner who has any volume of work in connection with partnership taxation should have this book. The tax-planning advice alone is worth the price. ☆

Partnership offers a refuge for low basis property

Do you have a client with a sizeable portion of his capital tied up in low basis property? Generally, such people are torn between the desire to diversify their investments, and unwillingness to pay the substantial capital gains tax. Have you ever considered the possibilities inherent in a partnership?

In the course of a survey of problem arising in drafting partnership agreements, published in the Fall, 1955, issue of the *Indiana Law Journal*, Robert S. Ashby and Albert L. Rabb, Jr., had these thought-provoking comments to make on this little-discussed use of the partnership form:

"Many lawyers have pondered the problem of the client with undiversified low basis securities. Stock in the family business is acquired in a tax-free reorganization by a larger concern; the former owners then find themselves with all their eggs in one basket and diversification possible only at the price of realizing a capital gain. The combination of inflation and tax-free organizations has made this problem a frequent occurrence. In many cases a partnership provides a solution

"If several persons, in like circumstances, but owning different securities or properties, contributed low basis assets to a partnership, each could obtain a measure of diversification, and the contribution would not result in any realization of gain for tax purposes. It is true that similar tax-free diversification could be obtained by contributions to a corporation in exchange for stock, but the resulting corporation would probably be a personal holding company. In addition, the corporation would ultimately face the problem of the imposition of accumulated earnings tax on the one hand or double taxation of dividends on the other. The additional difficulty and practical impossibility of getting the property, or any property, out of the corporation, without realization of gain or receipt of ordinary income, are well-known. In contrast, it is believed that the Code visits no tax penalty upon a partnership serving the function of a holding company. So long as the partnership continues, diversification may be achieved without tax additional to that which would be paid by the partners, if the properties contributed to the partnership were held individually.

Tax-free diversification

"Not only can the holder of low basis assets obtain tax-free diversification by means of a partnership, but also other important possibilities are open to him. If one of his partners contributes cash, or if one or more of the partners is willing to leave in the partnership cash accruing from current earnings, the partner contributing low basis assets can withdraw cash in an amount not exceeding the basis of his partnership interest without realization of gain. Thus, the partnership form apparently will permit what is in substance a tax-free liquidation of property contributed to the partnership to the extent of the basis of the contributed property.

"A third possibility involves distribution of partnership property in kind. The partner who receives diversified property in kind realizes no gain or loss. The property received in kind will have in the hands of the distributee its basis in the hands of the partnership or the remaining basis of his partnership interest, whichever is the smaller, but recognition of gain or loss will be postponed until disposition of the property received by the distributee. This generalization that property may be distributed in kind to partners without realization of gain or loss must, of course, be qualified insofar as such distributions constitute a sale or exchange of unrealized receivables and inventory items, or a payment for unrealized receivables to a retiring partner or a deceased partner's successor in interest. Since these rules merely insure that what is in substance ordinary income of the partnership will not, as to any partner, be converted into capital gain.

[*Robert S. Ashby is a partner in the Indianapolis, Ind., law firm of Barnes, Hickam, Pantzer & Boyd; Albert L. Rabb, Jr., is an associate in the Indianapolis firm of Bamberger & Feiblemen.*]

they give no cause for complaint. When ordinary income has been taxed to the partners as ordinary income and distributions are made when the partnership has only capital assets, then those capital assets may be distributed to a partner or partners without recognition of gain or loss. To this extent the movement of property into and out of partnerships is facilitated and made tax-free. Such freedom is unusual, if not unique, and the possibilities of its use will warrant consideration. Of course, the running of property into and out of a partnership by prearrangement will perhaps be subject to attack as a sham and illusory transaction resulting in a taxable exchange of properties which are not of like kind. Nevertheless, a large and legitimate area remains for use of the partnership as a refuge for low basis property." ☆

New partnership decisions this month

Pre-1954 partnership terminated on death of partner [*Certiorari denied*]. Frank and Howard were members of a partnership whose taxable year ended on January 31. Each filed his personal return on a calendar-year basis. The partnership agreement provided that if one died during the year, his distributive share was to be limited to a "salary." Frank died on November 21, 1947. As the partnership agreement did not contain a provision for continuation in the event of death, the partnership taxable year was held by the Fourth Circuit to have terminated on November 21. Howard was required to include in 1947 the partnership profits to date of death, less the salary distributable to Frank. This is not the normal case in which the decedent partner shares in the profits of winding up. At Frank's death his share was limited to the salary; here there is no reason for making a distinction between dissolution and termination. [The 1954 Code provides that the death of a partner shall not close the taxable year of a partnership.—*Ed.*] *Knipp, cert. den.* 10/14/57.

Wife not real partner; no capital and no service. Taxpayer and three brothers took their wives into their business as partners. This court upholds the finding that the partnership was invalid for tax purposes; there was no real purpose to have taxpayer's wife join the business. Her capital came from a bank loan guaranteed by taxpayer (repaid out of profits) and gifts from the taxpayer. Her powers were restricted by the partnership agreement, and she performed no services. *Sheerr,* CA-3, 11/6/57.

Gifts of partnership interests upheld. Taxpayers were partners in a plywood distributing business. One made gifts of fractional interests in the partnership directly to his three children; the other made the gifts in trust. A new partnership was then formed among taxpayers, the children and the trustee. Capital was a material income-producing item to the business; the new partnership is upheld as valid for tax purposes for the years 1944 and 1945. *Davis,* DC Ill., 10/30/57.

Errors on 1957 Form 1065. Line 11 should read "gross profit (line 2 less line 10)" [it now reads line 1 less line 10; line 1 is gross receipts, line 2 is gross receipts net of returns and allowances.—*Ed.*] The amount to be entered on line 8, Schedule N, page 4 (net earnings from self-employment) should be increased by any loss on line 31, page 1 or decreased by gain thereon [line 31 is net gain or loss from sale or exchange of property other than capital assets.—*Ed.*] *Notice* IRB 1957-50.

Jury finds family partnership valid. In 1940, taxpayer created a partnership of his wife, his wife as trustee for his minor children and himself to run a grocery business. In 1946 the business was reorganized into two partnerships and a corporation. The jury finds that the parties intended to create a bona fide partnership. *Belcher,* DC Ala.

Family joint venture found valid. [*Acquiescence*]. Taxpayer and two others bought some $23,000 worth of surplus bomb hoists. Taxpayer, his two sons, and son-in-law were to share in an undivided one-third interest. This arrangement, though informal, is found by the court to be valid. The Commissioner erred in including the sons' and son-in-law's shares of the profit in taxpayer's income. *Zack,* 25 TC 676, *acq.* IRB 1957-45.

Ordinary income on sale of inventory of dissolved partnership. Two brothers who had been engaged in the electrical-appliance business as partners transferred all the partnership assets, except for some war-surplus items, to a new corporation. These items they purchased from the partnership for $10,000 and sold in their own names at a substantial profit in the succeeding three years. The proceeds were held by the Tax Court to be ordinary income rather than capital gain; the brothers never held the war surplus items as an investment, but only as the stock in trade of a business operation. This court affirms. *Baker,* CA-5, 11/6/57.

Family partnership upheld; salaries to managers reasonable (Old Law). In 1941, taxpayer-husbands, two machinists, acquired equipment and began business with an investment of less than $5,000. The corporation was dissolved in 1943, and in the succeeding partnership the wives were partners. The court notes that in part the capital came from the wives' savings and through their contribution of their outside earnings to family expenses while the business was new. Moreover, under the *Culbertson* test, all partners had the requisite intent to join in business together. Nor did the court disturb the profit allocation among the partners; the Commissioner had argued that the low salaries ($10,000) to the husbands was unrealistic. Aside from the question whether it has authority to do so, it finds that, in view of the importance of capital and of the services of employees, the $10,000 salaries have not been shown to be too low. [Under the present Code, partnership interests acquired by gift are recognized if the profit is properly allocated to partners performing services and equally in relation to amount of capital invested. —*Ed.*] *Armitage,* DC Pa., 6/20/57.

Partner may deduct intangible drilling costs advanced by another. Taxpayer entered into a partnership agreement for the drilling of certain oil and gas leases. One of the partners was to advance the drilling costs and be repaid from the first proceeds of production. The court holds taxpayer may deduct his share of the drilling costs as incurred because he is responsible for the payment of these costs. [The court based its decision on a 1935 case, *McMurray,* 60 F.2d 843, *cert. den.* 287 U.S. 664, but did not comment on the many cases contra.—*Ed.*] *Carlson,* DC Okla., 12/13/57.

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

Disqualifying reasons for non-payment of benefits

WE NOTED in a recent Survey Analysis on Unemployment Insurance published by the Merchants and Manufacturers Association, Los Angeles, California, some worthwhile tips to keep in mind when considering the reasons for severance of employment which in some cases may raise a question of eligibility under a state unemployment insurance act. We thought that the following list of reasons which may disqualify an employee for benefits might prove worthwhile to some of our readers.

1. Does not like fellow workers
2. Does not like supervisor
3. Domestic circumstances
4. Enter armed services
5. Excessive absenteeism
6. Excessive demands for increased wages
7. Excessive tardiness
8. Failure to pay union dues
9. Illness or injury
10. Incarceration
11. Inebriation
12. Infraction of company rules
13. Jury duty
14. Lack of promotion
15. Leave of absence
16. Leaving for another job
17. Leaving state
18. Left because of trade dispute
19. Loss of license
20. Marriage
21. Occupational illness or disease
22. Personal affairs
23. Pregnancy
24. Received vacation, dismissal or severance pay
25. Receiving Workmen's Compensation
26. Refusal of suitable employment
27. Refusal of wage increase
28. Refusal to commute
29. Retirement from labor market
30. Sabotaging job
31. Sex perversion
32. Theft
33. To attend school
34. To enter self-employment
35. Unsatisfactory wages, hours, or working conditions
36. Vacation
37. Wants only part-time work
38. Wants work nearer residence

States offer training film on unemployment insurance

NEW YORK STATE in cooperation with the New England states has developed a color film with narrative accompaniment on the subject "You and Your Unemployment Insurance." It is intended that this film will be shown to unemployment insurance applicants so as to acquaint them with their rights and responsibilities under the unemployment insurance law. It permits greater distribution of uniform information and has so far been very well received throughout the state.

The film is also being made available as a matter of general interest to trade associations, professional groups and others who may be interested in this subject. Arrangements for viewing this film can be made by contacting Edward Mallin, administrative assistant, Division of Employment, 800 North Pearl St., Albany 1, N. Y.

CHANGE IN SICK PAY BENEFITS

RELATIVE TO the treatment of sick pay benefits for state income tax purposes, which appeared in the February issue of JTAX, the State of Vermont was listed under the heading "Total Payments Deductible under Employer's Plan." It should have been shown as "Same Amount Deductible as Federal."

Also since the chart was printed it has come to our attention that Minnesota requires that the employer's plan be submitted to the state for approval before a taxpayer is permitted to take the deduction on his individual income tax return.

Don't forget Gov't. aids for taxpayers

MANY TAX men are vexed at this season of the year by requests for tax advice from friends, employees of clients, etc. The questions are too elementary, the amounts too trivial, to justify professional services. It's not a bad idea, in many of these situations, to refer the questioner to the pamphlets put out by the government to help taxpayers.

The new *Tax Guide for Small Business*, 1958 edition, a 128 page pamphlet, covers in lay language a number of important areas, including Accounting Periods and Methods, Installment Sales, Inventories, Business Expenses, Repairs and Improvements, Depreciation, Traveling Expenses, Entertainment Expenses, Net Operating Losses, Sales of Fixed Assets, Social Security and Withholding Taxes, Self-Employment Taxes, Excise Taxes, and others. It can be had for 35c from the Supt. of Documents, Government Printing Office, Washington 25, D. C.

Also, the 1958 edition of *Your Income Tax* is now available. For use with returns for 1957, it is 128 pages (16 pages larger than last year, it is designed for the individual taxpayer. It's also 35c; order from Supt. of Documents also. ☆

New decisions

Retroactive compensation subject to full withholding even though part to be refunded. Taxpayer was a Government employee who was dismissed and received a lump-sum leave payment, on which tax was withheld. Subsequently he was reinstated and is to receive his pay for the time he was unjustifiedly discharged. The IRS rules that income tax must be withheld from this retroactive compensation even though taxpayer is also required to refund the lump-sum termination payment. *Rev. Rul.* 57-603.

Baseball players subject to payroll taxes on shares of World Series money. Postseason game receipts which are allocated by a baseball league to its affiliated clubs for distribution among the club's players on the basis of performance are taxable "wages" subject to payroll taxes. *Rev. Rul.* 57-456.

NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA,
JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

Current controversies over definitions, "point of sale" and "incidental purchases"

CURRENT HIGHLIGHTS in the taxation of foreign income were, of course, a topic given considerable attention at the National Foreign Trade Convention in New York recently. Clayton E. Turney, of the New York law firm of Dunnington, Bartholow & Miller, told the tax session of the conference that during the past year or so "there have been few important developments on taxation of foreign-source income, but this lack of major developments and the lesser ones that have taken place do contain some lessons and bits of encouragement and interest for us.

"I might mention first the absence of any development on the broad subject of preferential tax treatment of foreign-source income. It has been almost four years since the President first proposed legislation to give a 14-point reduction in the rate of tax on foreign-branch income and on dividends from foreign subsidiaries and to defer the payment of tax on foreign-branch income until it is remitted home. The President has repeated this recommendation from year to year, and Vice President Nixon in a recent speech advocated the same thing with a slight variation. But when in the course of the enactment of the Internal Revenue Code in 1954, the Administration put its technicians on the job of drafting bills for this purpose, the broad general objectives which can be so simply stated became tangled up in limitations, definitions, rules, and formulas.

"The House bill contained provisions to carry out the President's purposes, but the complexity with which they were drafted and the limitations attached to them gave rise to so many complaints from various groups of taxpayers, and got them to working so much at cross purposes, that the whole project was dropped from that bill by the Senate Committee. In 1955, another bill for the same purposes was drafted by the Treasury and introduced as H.R. 7725. It was a similar masterpiece of complexity. The Treasury had interpreted the President's broad recommendation as being inapplicable to certain types of foreign-source income. Percentage limitations with respect to these types of income, as well as domestic-source income and non-business income, were combined with elaborate formulas for determining eligible corporate relationships and with rules for determining the time when profits of a branch should be considered to have been remitted to the United States, and the result was a bill sufficient to discourage the interest of any legislator and most taxpayers.

British O. T. C.

"In the meantime, the United Kingdom has enacted the Overseas Trade Corporation provisions. [See page 175.—*Ed.*] This is a development worth some attention, though I do not intend to suggest that something modeled after those provisions should be our goal. Vice President Nixon referred to it recently in repeating the Administration proposals. On the other hand, one writer opposed to any relief for foreign-source income has argued that it could not rightly be used as a precedent for any legislation favorable to Americans in foreign business. I would concede that in essence the OTC provisions give no more than a deferral of tax liability to British shareholders of an OTC and not an exemption or rate reduction. Nevertheless, the broad outlines of a bill for one purpose can be adapted to both purposes, and to me the OTC provisions seem like a less complicated approach than H.R. 7725.

"Since legislative draftsmanship in the United Kingdom does not usually seem to shrink from complexity, I think that this comparative simplicity of the OTC provisions is due more to certain policy decisions than to skillful draftsmanship. For example, as to one point which has bothered our Treasury, that the provisions must not subsidize exports, the British felt that this principle is satisfied if the company pays a fair f.o.b. price for goods purchased for export, as a Western Hemisphere Trade Corporation must do under our law. Our Treasury's draftsmen felt that avoidance of an export subsidy required exclusion even of profits realized from activities abroad in connection with wholesale sales of merchandise exported from the United States. If it is really necessary to go that far to avoid an export bounty, one wonders why the Western Hemisphere Trade Corporation provisions have not created any international incidents.

"Neither did the British consider it necessary to exclude foreign manufacturing of articles destined for import into the United Kingdom. H.R. 7225 shows that our Treasury has felt that it must not benefit such operations, which is to say that such American-owned operations must be kept at a competitive disadvantage with similar foreign-owned operations, whose profits from manufacturing articles for importation into the U. S. can't be subjected to any U. S. tax. In defining eligible corporations, the U. K. provision precludes domestic trading but does not resort to a set of percentage-of-income tests to be met by the corporation. Instead, ineligible types of income are simply excluded from the benefits of the bill. I think that approach deserves a lot of consideration in comparison with a structure under which you are eligible for preferential treatment of 100% of your income, if 95% of your income is the right kind, but if you have only 94% of your income in the eligible category you get no preferential treatment on any of it. The British selection of dividend distribution rather than remittance to the home country as the time for taxation of the foreign income was the variation introduced by Vice President Nixon in his recent remarks renewing the Administration's previous proposals, and it might at least prove to be a simpler test, in some ways, than remittance to the U. S., as well as giving a longer deferment.

"The Revenue Service took the position under the 1939 Code that any purchasing of goods outside of the Western

Hemisphere disqualified a corporation as a Western Hemisphere Trade Corporation under the requirement that all of its business must be done in the Western Hemisphere. An effort was made to get a provision into the 1954 Code requiring disregard of purchases "incident to" the corporation's business. What eventually appeared in the Code was an exception for "incidental purchases," which might mean something less. In fact, the Treasury in its proposed Regulations came pretty close to taking the position that it meant nothing at all, by not only disregarding the dictionary definitions indicating that "incidental" could be used to mean the same as "incident to" but also giving a cumulative, combined effect to alternative dictionary definitions of the word, so that "incidental purchases" would be only those which met the double test of being both occasional and minor in amount. The N.F.T.C. Tax Committee joined in protests against this restrictive interpretation, and the final Regulations are in line with suggestions which it made that purchases should be regarded as incidental if they were *either* occasional *or* minor in amount—and that what was minor in amount should be determined by a comparison of the purchases with total business rather than with total purchases, as the proposed Regulations had provided. [See page 174.—*Ed.*]

"In this controversy, it seems to me that more attention has been given to a side issue than to the real point. The Treasury seems to assume that a purchaser is necessarily doing business in the country from which the goods are shipped to him or perhaps the country in which he takes title to the goods. No doubt purchasing activities do constitute doing business. But I do not see how, under the court decisions, a purchaser can be held to be doing business in a place where neither he nor his agent is present; specifically, I do not see how a corporation can be held to be doing business in Europe because it mails orders from its South American office to a supplier in Europe or because title to the goods so purchased passes to it in Europe. I hope that in all the argument about the amount of purchasing activity which is "incidental" the very proper issue of where, in each case, the purchaser is really doing business will not be allowed to go by default.

"In another instance, a little ground seems to have been lost between proposed and final Regulations on a point in which there is much interest. The proposed Regulations on "place of sale" under Section 861, relating to source of income, contained a pretty good summarization of the passage-of-title rule as established by the court decisions which rejected the Commissioner's efforts to apply a "place of contract" rule. [See box below.—*Ed.*] The proposed Regulations were an improvement over the

"PLACE OF SALE," BALANOVSKI, AND THE NEW REGS.

IT IS FREQUENTLY necessary to determine the source of income; e.g., for qualification as a Western Hemisphere Trade Corporation, or to show that income of a foreign corporation is from sources without the United States and therefore exempt from U. S. tax. Section 861 of the 1954 Code provides that the source of income from the sale of personal property is the place where the sale takes place. The implications of the Treasury's recent changes, in view of the importance of this concept in carrying on foreign business, are discussed by Mr. Turney on page 172. This controversy began with a simple GCM some ten years ago.

In 1947, the Commissioner issued a ruling (GCM 25131) in which he adopted the general rule that "a sale is consummated at the place where the seller surrenders all his right, title and interest to the buyer." However, this rule would not apply, the ruling continued, where a sales transaction was arranged in a particular manner for the primary purpose of tax avoidance. In such a case, other factors must be considered: the negotiations, the execution of the agreement, the location of the property and the place of payment to determine where the substance of the sale occurred.

This "passage of title" rule was followed in court decisions in the *Balanovski* case (236 F.2d 298, *cert. den.* 352 U. S. 968). Balanovski was a member of a foreign partnership who came to the U. S. to represent the partnership in buying autos and equipment. Technically, title passed in the U. S. from the partnership to the utlimate user—the Argentine Government. The district court for the Southern District of New York held that the sales were not made in the U. S. and that the partnership was not taxable on the profit. The Second Circuit reversed. The partner was, it said, far more than a mere purchasing agent and the partnership was engaged in business here. It added that it need not determine whether mere technical passage of title in the U. S. would make the profit "from U. S. sources" because the substance of the sales occurred in the United States.

Proposed and final Regulations

The Regulations under the 1954 Code as originally proposed said: "For the purposes of Sections 861 to 864, inclusive, sale of personal property shall be deemed to have occurred at the time when, and the place where, the rights, title, and interests of the seller in the property are transferred to the buyer. Generally, the time and place of the transfer depend upon the intention of the parties. For the purpose of ascertaining this intention, consideration shall be given to all of the circumstances of the sale, including the terms of the contract, the usages of the trade, and the conduct of the parties. Ordinarily, the sale shall be deemed to have been consummated at the place where the substance of the sale occurred. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership."

The final Regulations [Number 2-19, 12/17/57] said at Paragraph 1.861-7(c) "For the purposes of Sections 861 to 864, inclusive, and the Regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interests of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred." ☆

"INCIDENTAL PURCHASE" BY WHTC CLARIFIED

THE SERVICE has simplified the rules under which a firm can qualify as a Western Hemisphere Trade Corporation and thus enjoy a tax rate 14 percentage points below the prevailing U. S. rate. The significance of the change commented on by Mr. Turney, page 172, was stated clearly in simple language by Business International recently this way:

Section 921 of the 1954 Code defines a Western Hemisphere Trade Corporation as a U. S. corporation which: (a) does all of its business, other than incidental purchases, in the hemisphere; (b) derives at least 90% of its gross income from sources outside the U. S.; and (c) derives at least 90% of its gross income from conduct of a trade or business.

Now the IRS has issued Regulations attempting to clear up one of the cloudier matters of interpretation, i.e., what constitutes "incidental purchases" in deciding whether the company does all of its business in the Western Hemisphere. The new rules do not meet all taxpayer objectives, but they do seem to be somewhat looser than those the IRS proposed in April 1956.

Under the proposed rules, the Service would have held that purchases made by a WHTC outside the hemisphere would be incidental only if they were occasional and relatively minor in light of the facts presented by each case. Among the factors the IRS would have weighed were the ratio of outside purchases to the total, their frequency and their relationship to the conduct of the entire business.

In their final form, the rules hold that "incidental purchases" will not disqualify a WHTC, no matter what their nature, provided they are (1) nonrecurring or unusual in character, or (2) minor in relation to the total business done by the corporation. The Service would assume that these tests were met if the WHTC bought outside the hemisphere items worth no more than 5% of the firm's gross receipts from all sources for the year.

The IRS thereby persists in rejecting the view advanced by many business tax experts that the phrase "incidental purchases" means "purchases incident to the conduct of business." Also rejected is the notion that all purchases of items that do not become an integral part of products sold are "incidental." But the rules do stipulate, at the request of taxpayers, that: "Merely incidental economic contact with countries outside the Western Hemisphere will not disqualify a corporation" as a WHTC.

As an example of permissible economic contact, the Regulations cite the retention of title to goods by a WHTC solely in order to insure collecton by a company operating a mine in South America and shipping its products to England. A WHTC that buys parts in Germany for incorporation into motors that it makes in Argentina is another example; the IRS, provided that these parts are worth only 5% of the company's gross receipts, would hold the firm qualified. Some experts claim that another subsidiary of the WHTC's parent—located, say, in Venezuela—might buy and sell for the WHTC outside the hemisphere, thus avoiding any trouble with the "incidental purchase" rule.

Dividends, interest, capital gains received by a WHTC are not considered by the IRS to constitute income from the active conduct of a trade or business. They will, therefore, be disregarded in judging qualifications of a WHTC, as long as they constitute no more than 10% of its gross income. The Service notes that "adoption of a contrary position would have far-reaching and undesirable consequences in other areas" of Federal taxation. ☆

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ruling in 1947 in which the Service halfway accepted the court decisions. But the final Regulations reinstate the notion expressed in the 1947 ruling that there is an exception to the title-passage rule when title passage is artificially arranged for tax avoidance purposes, in which case the determination is to be controlled by the "substance of the sale."

"The Regulations elaborate on the 1947 ruling by enumerating some of the points to be considered with regard to this concept of "substance of the sale." They do not explain why, if they really make the substance of a sale, they need be considered only in abnormal cases. The reinstatement of this peculiar exception to the title-passage rule did not, I imagine, result from objections by taxpayers to the proposed Regulations. I would speculate that it was inspired by a dictum in the intervening court decision in the *Balanovski* case, which applied the established title-passage rule but included a quotation of the old ruling with its "tax-avoidance" exception, and by way of dictum said the title-passage rule might not always be applied. As an idealist in tax matters, I do not like rules of law that are supposed to change according to the motives of the taxpayer and the instincts of the administrators. However, if you are afraid of being considered an artificial title passage arranger, it probably has occurred to you that with a little extra trouble, the so-called substance factors can also be artificially arranged. At least, the new Regulations give you a sort of check list.

"On the legislative scene we find a pending piece of legislation to improve the operation of the foreign tax credit. This is Section 37 of the Technical Amendment Bill of 1957, which would grant a two-year carryback and a five-year carryforward of foreign tax credits. This would tend to smooth out the operation of the per-country limitation in cases of fluctuations in the effective rates of U. S. and foreign taxes. The fact that this provision is in this bill as reported by the House Ways and Means Committee would seem to give it a real chance of enactment in spite of a lack of sympathy from the Treasury Department. As a product of the legislative mountain this may seem like quite a mouse, but it is reassuring to see that Congress can become interested in improving the tax laws affecting foreign operations. ☆

New British rule on taxation of Overseas Trade Corp.

FOLLOWING THE plan suggested by the British Royal Commission on the Taxation of Profits and Income, this new British law defers the tax on foreign income until it is distributed. This is the same pattern as recommended in the Barlow and Wender study "United States Foreign Business Corporation" (5 JTAX 50).

The following summary of the provisions of the British Finance Bill indicates the pattern for prescribing deferment for so-called "Overseas Trade Corporations":

Who qualifies

Any company engaged in mining, oil drilling, agriculture, manufacture and

processing, public utilities and distribution, whose headquarters and management control are in the United Kingdom, but whose entire operations are conducted overseas, will qualify as an Overseas Trade Corporation, provided it meets the following requirements:

A company that carries on trade both in the United Kingdom and overseas must divide the two, and transfer its overseas operations to a separate company which may then qualify as an Overseas Trade Operation. A company that is "a principal company not itself carrying on a trade, but having a subsidiary company which is an Overseas Trade Corporation and which is carrying on a trade outside the United Kingdom . . ." may also qualify, provided that it has no other subsidiary resident in the United Kingdom that is *not* an Overseas Trade Corporation.

Although trade in the United Kingdom ordinarily disqualifies a company from Overseas Trade Corporation classification, companies whose operations comprise the production of commodities —e.g., rubber, minerals, tea—of a kind ordinarily bought and sold by brokers or agents in the United Kingdom, will be eligible as Overseas Trade Corporations if they conform to the requirements in all other respects

Disqualifications

Certain types of businesses are automatically disqualified: banking; lending of money or the providing of capital or credit facilities for entering into hire-purchase agreements with the public; dealing in securities; insurance; shipping or air transport; and where the receipts consist primarily of payments which are either: (a) payments for the services of individuals who are ordinarily resident in the U. K., being services of a kind ordinarily performed by individuals in the course of a professional or vocation, or (b) payments in respect of, or of the copyright in, iny literary, dramatic, musical or artistic work the author of which is ordinarily resident in the United Kingdom.

The bill makes it clear that the whole of the transactions of Overseas Trade Commissions which purchase goods in the U. K. for marketing or distribution overseas will be subject to the closest scrutiny and control. Specifically, a company purchasing goods in the United Kingdom will be disqualified as an Overseas Trade Corporation if:

1. Delivery of the goods is taken by the company in the United Kingdom otherwise than on board a ship or aircraft in which the goods are exported.

2. The seller does not bear the whole of the insurance, commission and other charges and expenses incidental to the delivery of the goods on board.

3. The company provides any services in respect of, or incurs any charges for insuring, preserving, warehousing, transporting or otherwise dealing with, the goods while they are in the U. K.

Nor will it be possible for an Overseas Trade Corporation to purchase goods at specially arranged prices. The powers which the Inland Revenue authorities already have to inquire into all transactions between United Kingdom-resident and foreign-resident companies are extended under this new act to cover Overseas Trade Corporations. All the dealings between an Overseas Trade Corporation and other companies must be conducted in the manner of "independent persons dealing at arm's length."

The benefits

The bill exempts from United Kingdom income tax and profits tax the *trading* income of an Overseas Trade Corporation, as distinct from income arising from investments, or from property other than that which is directly used for the purposes of the company's own trade. The main benefits, therefore, will be enjoyed by those companies who plan to plough back their earnings into their overseas operations. Companies which operate in territories where double taxation relief does not apply at all or where the local rates are substantially lower than the U. K. rates, will not be handicapped in their competition with rival concerns in those territories.

When an Overseas Trade Corporation declares a dividend out of its trading profits, income tax will be assessed and charged on the company in the usual way. If the recipient is a United Kingdom company, the dividends will be subject to profits tax as well. However, a shareholder who is not a resident of the United Kingdom may apply for a refund of the U. K. income tax; for this purpose other Overseas Trade Corporations, or holding companies which qualify as Overseas Trade Corporations, will be treated as nonresidents.

New foreign decisions this month

Vacation time abroad qualifies as foreign presence of "510 full-day rule." A taxpayer physically present in a foreign country or countries for 510 full days during a period of 18 consecutive months may exclude a portion of his earned income from sources without the U. S. The Service rules that vacation time in foreign countries will qualify as foreign presence. *Rev. Rul.* 57-590.

Certificate of Compliance not required from aliens in transit. Alien's in transit through the U. S. who stay here not more than five days are not required to obtain a Certificate of Compliance if there is no question of taxable income. *Rev. Rul.* 58-7.

Seamen employed by U. S. cannot exclude foreign income. Taxpayer, a U. S. citizen, was employed on a shuttle ship sailing between Korea and Japan. He was paid wages by private shipping lines as general agents of the U. S. from funds specifically supplied by the U. S. The IRS rules he cannot exclude his compensation from gross income even though he is phyisically present abroad 510 days or more out of 18 consecutive months. The Code specifically denies the tax exemption when the amounts are paid by the U. S. or an agency thereof. Taxpayer was so paid despite the intervention of the private shipping line. *Rev. Rul.* 58-4.

Mexican Mercantile revenue tax not an income tax. Taxes imposed by Mexico under the 1947 Mercantile Revenue Law do not constitute income taxes and are therefore not allowable as a foreign tax credit. This tax is, the IRS holds, imposed on transactions rather than on the income from them. *Rev. Rul.* 58-3.

Miscellaneous new decisions this month

Pin-ball machines paying premiums taxed as gambling devices. The Seventh Circuit held that the term "so-called slot machines" used in 1954 Code Sec. 4462 (a)(2) referred only to "one-armed bandits." The Supreme Court reverses.

The machines here involved an element of chance, were operated by coin, and persons winning could receive cash for any free games won. The purpose of the statute is to tax gambling devices, regardless of structure, at a higher rate. *Korpan,* Sp. Ct., 6/17/57; similarly *Hunt,* Sp. Ct., 6/24/57.

Legion post subject to wagering tax; Section 101 exemption inapplicable to wagering pools. Upon enactment of the wagering tax, the Legion post entered into a joint venture with two individuals who had previously operated lotteries to operate them as a Legion enterprise. One lottery was a wagering pool as to which, the district court found, the law allows no exemption. While the other was a lottery, the Legion's exemption from income tax, under Section 101 of the 1939 Code, does not prevent tax. Congress intended to exempt only occasional small drawings. Here the lottery was a business activity of considerable magnitude. The Court of Appeals affirms. *Edgewood American Legion Post #448, Inc.,* CA-7, 6/12/57.

EXCESS PROFIT TAX

Equity capital may be a negative amount in computing capital reduction. In computing the daily capital addition or reduction under the provisions of the Excess Profits Tax Act of 1950 it is necessary to determine the amount, if any, by which the equity capital of the taxpayer at the beginning of the taxable year exceeds, or is less than, its equity capital at the beginning of its first taxable year. The Tax Court rules that where there was an excess of liabilities over assets at the beginning of the taxable year, equity capital may be a negative amount—less than zero—for the purpose of computing the taxable year capital reduction. *Mid-Southern Foundation,* 28 TC No. 102.

Premium paid to obtain loan is interest on borrowed capital. Taxpayer corporation borrowed various sums of money paying 6% interest. On each occasion a certain amount was withheld by the lender as "premium for making the loan." The court concludes that such "premiums" are interest on borrowed capital for EPT. *L-R Heat Treating Co.,* 28 TC No. 99.

Interest determined on potential EPT deficiencies eliminated by carryback. This decision resolved several separate issues involving the computation of interest on potential EPT deficiencies wiped out by a carryback of losses and unused excess profits credits from a later year. Taxpayer suffered a net operating loss in 1945. (1) Taxpayer had deferred a portion of its 1943 excess profits tax. Under the provisions of Section 710, there would be no interest on this deferral to the extent that Section 722 relief was applicable. The Commissioner took the position that the EP tax was wiped out, not by the 722 relief, but by the loss carryback. Thus, he said, no relief was granted and the deferment of EP tax requires interest on the excess of the deferment over the relief (zero). The court holds that taxpayer cannot be deprived of its right to the interest-free deferment because of the later operating loss even though the Excess Profits Tax Council determined a constructive average base period net income "for carryback and carryover purposes only." (2) The 1942 EPT liability was wiped out by an unused EPT credit from 1944. However, interest was properly charged on the difference between the deferment and 1942 relief alone. The Government should not lose the interest due it because of the accident of the credit carryback from another year. (3) Interest on a deficiency eliminated by a carryback begins to run one year, the Code provides, after the filing of a claim. Taxpayer was entitled to interest for 1942 only after a claim was filed for that year; the filing of a Section 722 claim specifying the later years showing a credit in excess of income was not sufficient notice to the Commissioner of the credit carryback. *Industrial Rayon Corp.,* Ct. Cls., 10/9/57.

"Gross receipts" under EPT growth formula includes excise taxes. The Tax Court held that in determining whether a brewery's gross receipts showed an increment of more than 150% under the growth formula used for excess profits tax purposes, Federal and state beer excise taxes are includible in the receipts. This court affirms. *Lucky Lager Brewing Co.,* CA-9, 6/24/57.

Amended EPT relief claim calling for investigation of new facts barred by limitation period. Taxpayer filed an original application for excess profits tax relief under Section 722 for the fiscal year 1945. Later, after the statute of limitations had run, it filed an amended claim claiming the benefit of a constructive unused excess profits credit carryover and carryback from the fiscal years 1944 and 1946. The court finds that the original application did not adequately apprise the Commissioner of the requested carryover and carryback, and since the amended claim called for an investigation of new facts and circumstances not called for by the original application, it was barred by the statute of limitations. *Headline Publications Inc.* 28 TC No. 148.

Vacaion pay is "class of deductions" for EPT relief. For purposes of eliminating abnormal deductions in the EPT base period pursuant to 1939 Code Section 433(b)(9), vacation pay constitutes a "class of deductions" separate and distinct from routine salaries, whether the vacation pay is accounted for as a part of cost of goods sold, or as deductions from gross profit. Therefore, where the vacation pay incurred by taxpayer for 1949 was in excess of 115% of the average amount of vacation pay for the four previous taxable years, and the increase was not a consequence of an increase in gross income, or a change in business operations, taxpayer is held to have properly eliminated the excess amount as a deduction in computing its base period net income. *National Biscuit Co.,* 29 TC No. 44.

Retirement benefit payments one "class" of abnormal deductions for EPT. The 1939 Code provided for EPT relief by permitting corporations to increase their base period excess profits net income by eliminating deductions abnormal in class. A cereal mill increased its EPT net income for each of its base period years by removal of deductions for various types of employee benefits which it said were of different classes and were abnormal in their class. The court finds that the expenditures were for the single "class" of deductions as the word "class" is used in the EPT relief provision, and that when considered as one "class," the total deductions were all normal to the mill. Relief is denied. *Quaker Oats Co.,* 28 TC No. 69.

Affiliated corporation required to compute its actual excess profits net income. Taxpayer filed a consolidated return with its parent for two months in 1946 and filed a separate return for the balance of that year when it was unaffiliated. Since taxpayer was in existence

throughout the entire base period it is required to compute its actual excess profits net income for 1946 in determining the average base period net income. Taxpayer's contention that for the two month period in which it was affiliated it had no excess profits net income and could therefore use a monthly average computed for the other months in 1946 is held to be without merit. *Underwriters Service, Inc.* 28 TC No. 37.

Adjustments mitigating limitations statute apply to inconsistency before base period. In 1935, taxpayer paid AAA processing taxes to its vendor, a controlled corporation, in escrow pending determination of the constitutionality of the tax. The AAA was declared unconstitutional in 1936 before taxpayer's 1935 return was filed. The return accordingly excluded the deduction for the tax payment which was refunded to taxpayer in 1936. The Service concedes the correct treatment is to deduct the tax in 1935 and take up the refund as income in 1936, a base period year for World War II excess profits tax. Taxpayer further contends that the section of the excess profits law mitigating the effect of the limitations statute when inconsistent positions are adopted [corresponding in purpose to Section 1311 of the 1954 Code.—*Ed.*] requires an adjustment which will also in effect allow the deduction for 1935. The court finds nothing in the mitigation section which would limit its application to base period years and accordingly allows the adjustment for 1935. *National Biscuit Co.*, Ct. Cls., 12/4/57.

Court of Appeals has no jurisdiction in 722 case. Taxpayer filed an application for relief under Section 722 for 1941, claiming a constructive average base period net income for that year. Its claim was determined and allowed. The Tax Court held the allowance of this claim did not preclude the Commissioner, as a matter of law, from denying use of the same constructive average base period net income in excess profits tax returns for the years 1942-45. This decision of the Tax Court is not appealable, since Section 732 gives the Tax Court exclusive jurisdiction over Section 722 claims. The Court of Appeals has no jurisdiction to review. *Standard Hosiery Mills,* CA-4, 11/7/57.

Thrift certificates do not qualify as borrowed capital. Nonnegotiable thrift certificates issued by industrial loan corporations to its customers to evidence the receipt of funds, are held to be in the nature of "pass books" evidencing deposits rather than investment securities. Accordingly they do not qualify as "certificates of indebtedness" and would not be taken into account in determining borrowed invested capital for excess profits tax purposes. *Jackson Finance & Thrift Co.*, 29 TC No. 31.

Paper box manufacturers denied 722 relief because of change in character of business. A manufacturer of corrugated boxes claimed excess profits tax relief under Section 722(b)(4) because of an increase in its capacity for operation and production. The court finds that the manufacturer failed to demonstrate that its increased capacity during the base period, even with the application of the pushback rule, would have resulted in increased base period net income. It therefore concludes that the manufacturer failed to show that its actual average base period net income is an inadequate standard upon which to determine its excess profits taxes. *Lanzit Corrugated Box Co.*, 29 TC No. 36.

Internal mismanagement no grounds for EPT relief. Taxpayer was formed to acquire all the property and assets of two competing newspapers in 1927 in exchange for its stock to be held under a voting trust agreement. The trust was terminated in 1940 following litigation and attacks on taxpayer's management by some of the stockholders. Taxpayer requested EPT relief, contending that the allegation of mismanagement adversely affected its business during the base period. The relief is denied because any depression in earnings was caused by taxpayer's own corporate acts rather than by some external event. *Clarksburg Publishing Co.* 28 TC No. 56.

Installation of new machines does not merit EPT relief. The Tax Court held that taxpayer's installation of labor-saving machinery during the base period was not shown to have caused diminution or interruption of "normal production, output, or operation." Excess profits tax relief is denied. This court affirms. *Fulton Foundry and Machine Co.*, CA-6, 10/26/57.

Pre-consolidation EPT credit not available to successor. An unused excess profits credit of a bank prior to its consolidation with taxpayer is not available to taxpayer as a carryforward after the consolidation on the grounds that the income of taxpayer was not produced by substantially the same business which had the excess profits credit. *Old Nat'l Bank in Evansville,* 28 TC No. 123.

Can't use both growth formula and 722 relief. Taxpayer and the Commissioner agreed on a constructive average base period net income for its rubber textile department under the two-year pushback rule of Section 722(b)(4). Taxpayer argued that it should add this to the actual income of the rest of the business for each year and use the growth formula. The Tax Court found nothing to distinguish this case from others in which it held that these two methods of relief could not be used together. This court affirms. *Dayton Rubber Co.*, CA-6, 10/31/57.

EPT relief based on abnormal income denied. Taxpayer sought excess profits tax relief claiming abnormal income from producing wells completed in a leased oil pool. However, the court finds that the income claimed to be abnormal did not result from "exploration, discovery, or prospecting" extending over a period of more than 12 months as required by 1939 Code Section 456, and denies the requested relief. *Big Four Oil & Gas Co.*, 29 TC No. 5.

EXEMPT ORGANIZATIONS

Nonprofit home for aged is taxable; all inmates pay. A home for aged people which does not accept charity guests and which requires the discharge of guests who fail to make certain required monthly payments is held not entitled to tax exemption as an organization operated exclusively for charitable purposes, even though it is on a nonprofit basis. [The facts show that the organization received contributions but not whether fees charged (for example, the monthly board of $100) covered costs.—*Ed.*] *Rev. Rul.* 57-467.

Donations to church operating private businesses not deductible [*Certiorari denied*]. Taxpayer was held to have operated a restaurant in her own name and not on behalf of a church to which she contributed all the income. Nor could this contribution to the church be deducted as the church was not organized and operated exclusively for re-

ligious purposes. In an attempt to apply religious principles to economic problems the church's principal functions consisted of various commercial activities carried on for profit in competition with privately owned enterprises. *Riker cert. den.* 10/14/57.

Publisher of anthologies of members' writings not exempt as business league. The IRS denies exemption to an organization which publishes anthologies of its members' writings, and arranges for radio and television programs based on the anthologies. The members furnish the writing without fee but they retain other publication rights, radio and screen rights, etc. The Code grants exemption to business leagues, etc., if they are not organized for profit and if no part of the net earnings inure to the benefit of private individuals. The IRS rules that this organization is merely a vehicle for the publication of its members work and that it is also engaged in an enterprise for profit in the sale of the anthologies and in arranging the radio and television programs. *Rev. Rul.* 57-453.

Exempt agricultural organization taxable on unrelated business. An organization engaged in the advancement and improvement of agriculture also purchased supplies and equipment for resale to its members. Although tax-exempt as an agricultural organization, it is held subject to tax on the income from resales of supplies and equipment. *Rev. Rul.* 57-466.

Parol evidence used to show charitable purpose of gift. Decedent had established a charitable trust with the local Kiwanis Club as trustee. At the same time he assigned a note to the club. While the instrument of assignment indicated that the note was in payment of compensation to the club for the administration of the trust, the court finds that the understanding of the parties was that it would be used to aid underprivileged children, and it was in fact so used. Its notes that the parties seemed to be unaware of the conflict between the document and the parties' intent. The court permits the introduction of this oral evidence of intent and allows a charitable deduction for the interest in the note. Any rule limiting oral evidence varying a written instrument is applicable only between the parties to that instrument and cannot be invoked by a third party, in this case, the Government, *Hebble Estate (Mustard, Ex'r)*, Ct. Clms., 10/9/57.

Release of frontage land to county not a contribution. The value attributable to land which was required to be released to a county for the widening of a road in connection with the sale of lots cannot be deducted as a charitable contribution. The cost of such land is to be added to the cost basis of the remaining property. *Rev. Rul.* 57-488.

No contribution deduction for reimbursement to State hospital. Payments to a State hospital to reimburse the State for the care of a patient do not constitute contributions or gifts to or for the use of a State for exclusively public purposes and are therefore not deductible. *Rev. Rul.* 57-211.

State trust for public functions exempt as political subdivision. Income realized by the Oklahoma County Utility Services Authority, a trust created by the state, from the furnishing of municipal utility services, and the interest paid on obligations issued by it are held exempt from the income tax. *Rev. Rul.* 57-151.

Contribution to State of an undivided present interest in a mansion for the Governor is deductible. A charitable contribution deduction is allowed for the present market value of a gift to a state of an undivided present interest of one-fourth of a residence to be used as a Governor's Mansion. The donor retained the other three-fourths interest which he leased to the state for five years with the right of either party to sell the entire property after the lease term and have the proceeds divided between them in accordance with their undivided interests. *Rev. Rul.* 57-511.

Contributions to joint drive deductible. Lump-sum contributions to an agent appointed by a group of exempt national health organizations to carry on joint campaign for soliciting contributions are deductible. *Rev. Rul.* 57-487.

Employees' beneficiary association can't qualify for exemption as social welfare organization. The IRS takes the position that an organization which cannot meet the requirements for a specific type of exemption because it cannot comply with a specific limitation may not be granted exemption under another broader class. Thus, it holds that an association which fits the description in Section 501(c)(9) as a voluntary employees' beneficiary association but cannot qualify for exemption because it fails to meet the requirement that 85% of its income be amounts collected from members and contributions by the members' employer, may not qualify for exemption as a social welfare organization under Section 501(c)(4). The IRS notes that it does not agree with *Pickwick Electric Membership Corp.*, 158 F.2d 272, in which a cooperative electric league was allowed exemption as a civic league though it could not meet the 85% test as a cooperative telephone company. *Rev. Rul.* 57-494.

Foundation controlled by individual denied to tax exemption; its income actually dividends to individual. A foundation was organized by taxpayer ostensibly for charitable purposes. The court denies tax exemption upon a finding that the taxpayer controlled its activities and expenditures, and devoted a substantial amount of its funds to aid his friends and promote his hobbies (soilless cultivation of vegetables, etc.). To get income into the foundation, taxpayer granted it a patent license, and then had it sublicense another corporation also controlled by him, in return for "royalties." The court finds: (1) the corporation paying the "royalties" was under no obligation to do so but made the payments voluntarily out of its surplus, and (2) the payments were taxable to taxpayer as dividends because they were spent at his direction for his benefit and his family. In effect they were distributed to and constructively received by him. *Best Lock Corp.* 29 TC No. 43.

No deduction for donations to exempt communal organization. Religious and apostolic associations organized for the purpose of operating a communal religious community where the members live a communal life following the tenets and teachings of the organization are exempt from tax under Code Section 501(d). However, contributions to or for the use of such an association are not allowable as charitable deductions because the association's income, derived principally from contributions and the sale of manufactured articles, goes into a community chest and inures to the common benefit of its members. *Rev. Rul.* 57-574.

TAX STRATEGY. NEWS OF THE REVENUE SERVICE
Effective tax procedures
EDITED BY MARTIN M. LORE, LL.B. CPA

Must you pay full tax assessment before suing in the district court?

by **J. Q. RIORDAN**

Is the Tax Court the only forum for a taxpayer who wants to contest an assessment before paying it? A few years ago the answer would have been an unqualified yes; but recently there have been cases where district courts have permitted suit by taxpayers who have paid only part of the assessment. The issue is now before the Supreme Court, which has granted certiorari in the Flora case. Mr. Riordan, a New York attorney, analyzes the practical problems lying behind this procedural point and concludes that good administration requires that the old rule of pay first, sue later, be firmly established, but with a qualification to cover hardship cases.

THE SUPREME COURT has granted taxpayer's petition for a writ of certiorari to review the decision of the Tenth Circuit in the *Flora* case. It will now decide whether a taxpayer must pay first and sue later, (the "old rule") or sue first and pay later, (the "new rule"). It is suggested that the Court should stay with the "old rule" with a gloss that will permit suits to be brought in extraordinary circumstances where the taxpayer would suffer irremediable damage if not permitted to sue. If either the old rule or the new rule is adopted without qualification, results will be unsatisfactory.

Prior to 1954, it had been generally assumed that a taxpayer had two choices with respect to tax deficiencies. He could pay the full amount assessed and sue for a refund in the district court or Court of Claims. If he could not, or chose not to, pay the deficiency in full he could contest the deficiency only in the Tax Court. Generally this old rule of "pay first, sue later," has worked well. The rule is not precisely stated in any statute. Legal support for the general rule must be spelled out of a number of statutory provisions and pertinent legislative history and cases, most of which did not involve factual situations like those in the *Flora*[1] and *Bushmiaer*[2] cases.

While many precedents more or less directly in point can be cited in support of either the *Flora* or *Bushmaier* decision, the fact is that the precise problem now before the Supreme Court, (i.e., the right to sue for a refund where only partial payment has been made of a year's income tax assessment) may be said to have been decided for the first time on July 26, 1954, in the *Hanchett* case.[3] In that case the district court was persuaded by the language in the opinion of the Second Circuit in the *Coates* case[4] and of the Third Circuit in the *Sirian Lamp* case[5] that the taxpayer could maintain his suit for refund even though he had not fully paid the deficiency assessed. The district court decided for the taxpayer but stated that the Government's arguments were not without force and that "if an overriding policy of taxation requires a different result, it would more appropriately come from an appellate court."[6] The *Hanchett* case went to trial on the merits and the Government prevailed. Thus the procedural question was never appealed.

Beginning with the *Hanchett case* in 1954, a number of taxpayers have sought to bring suits for refund in the district courts on the basis of only partial payment of tax deficiencies assessed. The litigation has produced support for the old rule, "pay first, sue later," in two district court decisions, *(Flora* and *Bushmiaer)* and in one circuit court decision *(Flora)*, whereas the new rule "sue first, pay later," has found support in one district court decision *(Hanchett)* and in one circuit court decision, *(Bushmiaer)*.

In short, the present law is unclear and unsettled. The Courts which have recently considered the question have come to completely opposite conclusions.

Because the *Hanchett* case went to trial on the merits, the first appeals court to consider the problem was the Eighth Circuit, in the *Bushmiaer* case; the court split and the majority and minority opinions set forth the factors on each side of the argument.

Bushmiaer case

On May 27, 1955 the district court decided that Bushmiaer could not maintain a suit for refund of a partial payment. The district court stated that it had considered precedents cited by the Government[7] and the legislative history of the statute establishing the Board of Tax Appeals,[8] as well as precedents favoring the taxpayers, including the *Coates* case, the *Sirian Lamp* case and the *Hanchett* case.

The district court held against the taxpayer[9] stating that, "since the complaint shows on its face that plaintiffs have not paid the entire tax assessed, they cannot

[1] Flora v. U. S., 246 F.2d 929 (10th Cir. 1957).
[2] Bushmiaer, 230 F.2d 146 (8th Cir. 1956).
[3] Hanchett v. Shaughnessey, 126 F.Supp. 769 (DC N.Y., 1954).
[4] Coates v. U. S., 111 F.2d 609, 610 (2nd Cir. 1940): "It is pressing technicality beyond all bounds to say that a taxpayer who has made a return on an excessive basis and has paid installments which are more than the correct amount of tax before discovering his error, must pay the remaining installments indicated by the incorrect return on pain of losing his remedy to recover the overpayment." It should be noted that (1) while the *Coates* case was pending the remaining installments had been paid and such fact had been set forth in a supplemental complaint, and (2) no deficiencies were involved since the taxpayer was seeking the refund of taxes paid on his original return so that there was no possibility of litigating in the Tax Court.
[5] Sirian Lamp Co. v. Manning, 123 F.2d 776 (3rd Cir. 1941). In this case the Court of Appeals relied on the fact that the defendant was the Collector, individually and not the United States and that the two were not in privity. The court held therefore that the statutory restrictions on bringing suit against the United States alleged to exist by the Government (i.e., that the full deficiency must be paid) could not be applicable. The case would appear to have no precedential value where the taxpayer sues the United States and in view of Sec. 7422(e) (formerly Sec. 3772(d) added to the Code in 1942) no precedential value today where suits are brought against the Director.
[6] Hanchett, Note 3, *supra*, p. 771.
[7] Cheatham, 92 U.S. 85 (1876); Friebele, 20 F. Supp. 492 (DC N. J., 1937); Suhr, 18 F.2d 81 (3rd Cir. 1927).
[8] Section 900, Revenue Act of 1924, Tit. IX, Ch. 234, 43 Stat. 253. 336, H. Rep. No. 179, 68th Congress, 1st Session (1939); Phillips, 283 U.S. 598 (1931) and the Old Colony Trust Co., 279 U. S. 716 (1929).
[9] Bushmiaer, 131 F.Supp. 589 (DC Ark., 1955).
[10] Note 2, *supra*.

maintain this suit. Their remedy to test the validity of the assessment was by proceeding in the Tax Court . . ."

On February 21, 1956, the Eighth Circuit in a split decision reversed the district court.[10]

The majority decision stated that it found no requirement in the language of the statute[11] establishing the jurisdiction of the district court in tax cases, nor in the language in the pertinent section of the Code governing claims for refund[12] that the taxpayer must allege in his claim for refund or complaint that he had paid the full deficiency assessed.

The majority was persuaded by the language in the *Coates* and *Sirian Lamp* opinions and stated that its decision would not cause "let or hindrance" in the collection of assessed taxes since the Government could always invoke its drastic summary collection remedies.[13]

The Bushmiaer dissent

In a lengthy opinion, the majority distinguished each of the cases beginning with the *Cheatham* case which were cited by the district court. It largely ignored the legislative history of the statutes creating the Board of Tax Appeals.

Judge Woodrough dissented.[14] He relied heavily on the legislative history of the statute establishing the Board of Tax Appeals. He also cited the Supreme Court decision in the *Phillips* case, for the proposition that the aggrieved taxpayer has two choices: "(1) To contest the assessment before the Board (or its successor, the Tax Court) without prepaying tax or interest or (2) To pay the tax and sue in district court to get back any illegal excess paid and interest. The Commissioner has been administering the collection of income taxes on that basis for more than thirty years. The collectors have understood it to be according to law, millions of taxpayers have had it so explained to them and believed it and it has been found to work.

"I think the system of tax collection applied since 1924 (when Congress created the Board of Tax Appeals), which affords the taxpayer only the two means of contesting the validity of income taxes assessed against him, is supported by the law and that there is no legal sanction for predicating a civil action for recovery of tax upon token payments as had been here attempted."

Judge Woodrough specifically rejected the majority suggestion that the taxpayer's right to sue for the refund of a partial payment would not impede revenue administration because the Service had available the drastic and summary collection methods. He further stated: "No weight should be ascribed in deciding this case to the existence of powers to collect unpaid portions of taxes by seizures. We are concerned here with the lawfulness of the system of income tax administration of the United States as it has been and is conducted. The billions are collected under it in the faith that it is lawful. We must uphold it or strike it down solely upon our answer to that question, whether it is or not. In the case before us, plaintiffs are attempting to obtain adjudication upon the validity of taxes that have not been collected. They have delivered partial payments, insignificant, compared to the tax, and request adjudication that the whole tax is illegal. I think all that is presented is an ingenious device to induce the court to disobey the long-settled and fundamental prohibition that had been lawfully, and wisely, directed against courts interfering with the collecting of taxes in the first instance."

In discussing the language of the pertinent statutory provision, Judge Woodrough stated: "It is true there never has been any statute declaring in so many words that taxpayers are limited to the two choices of ways to contest their taxes. It is necessary to consider several statutory provisions to get at it, but I see no reason to believe that the administration of the tax system on the basis of the two choices is or has been without support in the law."

Judge Woodrough found support for his position not only in Code Section 7422 and 28 USCA §1346(a), but also in Code Section 7421, which prohibits the courts from using their equity powers to interfere with tax collection.

Flora case

Five months after the circuit court decision in the *Bushmiaer* case another district court decided that the taxpayer Flora could not maintain a suit for refund of a partial payment. The district court stated: "Historically, it has been the established policy of our tax system for the taxpayer to pay first and litigate afterwards. This is the method of corrective justice consistently followed by the lower courts since the *Cheatham* decision." The court stated that this general rule had been questioned only recently in the *Bushmiaer* case which it found to be in direct conflict with the *Suhr* case.[15]

The Court of Appeals for the Tenth Circuit decided that the suit should not have been maintained and remanded the case to the district court with direction to dismiss the action without prejudice. The Court of Appeals relied upon the same precedents as those relied upon by the district court. The court stated that a refund suit for partial payment of tax assessed as a deficiency was in fact a suit for the redetermination of the deficiency remaining unpaid and therefore could not be maintained since the Supreme Court in the *Dobson*[16] case had held that "Congress has invested the Tax Court with primary authority for redetermining deficiencies, which constitutes the greater part of the tax litigation." The Court of Appeals rejected the argument that suits for partial payments do not include a review of the total assessment or the remaining deficiency not paid:[17] "Such an approach is unrealistic and serves only to defeat conveniently the established purpose and function of the Tax Court."

If the Supreme Court adopts the old rule, there may be cases in which taxpayers without fault will suffer irremediable damage. If the Supreme Court adopts the new rule, it will work a great change for the worse in the administration of the revenue laws which has been generally satisfactory under the old rule.

Difficulties under new rule

Various difficulties will undoubtedly arise if the pay first, sue later, rule is overturned. For one, established administrative practices and taxpayer education will be upset (see dissenting opinion in the *Bushmiaer* case).

The Government will be forced either to seize the property of taxpayers or to forego seizure and to permit refund suits based on partial payment, in which event the proper jurisdiction of the Tax Court would be undermined. The circuit court in the *Bushmiaer* case correctly stated that there would be no barrier in law which would prevent the Government from using its drastic collection remedies. While this is true as a matter of law, a rule that would require the Government to use such drastic remedies

[11] 28 U.S.C.A. §1346(a)(1).
[12] Int. Rev. Code of 1954, Sec. 7422.
[13] Note 2, *supra*, p. 152.
[14] Note 2, *supra*, dissenting opinion, p. 152-155.
[15] Flora v. U. S., 142 F.Supp. 602 (DC Wyo., 1956).
[16] Dobson v. Comm'r., 320 U.S. 489, 502 (1943).
[17] *Flora*, note 1, *supra*, p. 931.
[18] Sec. 6511.
[19] Sec. 6532.
[20] Miller v. Standard Nut Margarine Co. of Florida, 284 U.S. 498 (1932).
[21] Sturgeon v. Schuster, 158 F.2d 811 (10th Cir. 1947).

frequently would produce a most unsatisfactory tax administration.

1. If the Government is forced to use these remedies on a large scale, it will affect adversely taxpayers' willingness to perform under our voluntary assessment system.

2. It will put the burden on the Government to seek out for seizure the property of every taxpayer who chooses to sue for the refund of a partial payment. Often, the Government will not be able to do this without extraordinary and costly effort and in some cases it may not be able to do it at all.

3. The use of the drastic-collection remedies would often cause inconvenience and perhaps hardship to the creditors, debtors, employers, employees, banks and other persons doing business with the taxpayer.

If a taxpayer is permitted to sue for the refund of a partial payment of an assessed tax, the Government will be obliged to determine whether it must or should counterclaim for a judgment in the amount of the assessed tax remaining unpaid. Under Rule 13 of the Rules of Civil Procedure, the argument can be made that such a counterclaim is compulsory. The practice of the Government in these cases has been to counterclaim, although this practice has been based not only on the fear that such a counterclaim is compulsory but also in part on the desire to avoid repeated litigation should the taxpayer lose his suit for refund. Query: whether in these circumstances the burden of proof with respect to the counterclaim has been shifted to the Government?

Danger of repeated litigation

Assume that a $50,000 deficiency has been assessed and that five disputed issues are involved, each producing a $10,000 deficiency. Assume further that the taxpayer has paid $10,000. Assume either that a jury gives a general verdict against the taxpayer or that a judge determines that as a matter of law the Government is correct with respect to one of the issues, and therefore refuses to consider the other four issues on the ground that in no event can the taxpayer recover his partial payment. Has anything been decided in the case of a general verdict or with respect to the four undecided issues in the case of the court's judgment? If the taxpayer pays an additional $10,000 of tax, will he not be permitted to bring another action for the recovery of the second $10,000? In an extreme case, the taxpayers' liability for the year in question might require five law suits before the year would be finally adjudicated.

Difficulties under old rule

Assume that a taxpayer has a valid reason for not having petitioned the Tax Court to redetermine a tax deficiency. For example, consider the case where the relevant decisions of the court of appeals in the taxpayer's circuit at the time the 90-day letter was issued were such that the taxpayer was advised he probably would not prevail if he contested the proposed deficiency. Assume that, thereafter, the Supreme Court decided a case which made it sufficiently probable the taxpayer would prevail that he is advised he should file a refund claim, and assume further that the Government takes no action on his claim. If the deficiency assessed against the taxpayer were so large that he could never hope to pay it, under the old rule he would never be able to maintain his action.

Similarly, if the taxpayer had been paying the deficiency on an installment basis, would he be obliged to file claims for refund of installments within two years from the time of payment?[18] Assume that the Service rejects the claim for refund. Would the taxpayer be obliged to bring suit within two years?[19] Yet, the taxpayer may not have paid the entire assessment within that time. In these situations, it appears that under the old rule the taxpayer would be denied the day in court to which he should be entitled.

The abandonment of the old rule might also produce a rash of procedural complications and uncertainties in the case where a taxpayer continues to pay part of the assessment while his suit for refund is pending. For example, if he prevails, how will he recover the amounts paid since the suit began? Will the trial court have the right to give judgment with respect to additional payments, or will the taxpayer be obliged to file another claim for refund and bring another suit? If so, is it clear that the Government will be collaterally estopped from raising any new defenses? What will be the continuing validity of the unpaid assessment? Can the Government continue to collect the unpaid assessment after judgment in the first litigation, or will the trial court enjoin further collection?

The old rule should be maintained, but an exception to its operation should be permitted in extraordinary circumstances where the taxpayer will suffer irremediable damage if he is not permitted to bring suit before paying the total assessed. In *Standard Nut Margerine*[20] the Supreme Court held that despite the literal prohibition in Section 7421, (Section 3653 of the 1939 Code) against suits for restraining the assessment or collection of any tax, injunctive relief would be granted in "special and extraordinary circumstances." If a taxpayer is permitted in extraordinary circumstances to enjoin the collection of tax which could be collected by seizure of his property, he should be permitted in extraordinary circumstances to sue for refund of a partial payment where he can't pay the full deficiency assessed.

This possibility was hinted in *Sturgeon*.[21] In that case, the Government had assessed a substantial deficiency. Without admitting that any taxes were due, the taxpayer deposited with the Collector a sum much less in amount than the deficiency assessment, to be used in the payment of any additional taxes that might be finally determined to be due. The taxpayer filed claims for refund. Three months later, he brought a suit alleging in his complaint that all taxes due had been paid; that the assessment was erroneous, arbitrary and illegal; that he was unable to pay the deficiency and that the Collector should be restrained from the levying upon his business and disposing of it at forced sale which would result in an irreparable injury for which there was no plain, speedy and adequate remedy at law. The taxpayer also sought the refund of the partial payment which he had made.

While the decision relates only to the prayer for injunctive relief, which was denied, the opinion hints that the court might have permitted the taxpayer to maintain the action had he shown the presence of extraodinary circumstances.

The suggested procedure was attempted in the *Hanchett* case. Government counsel invited the taxpayer in that case to amend his complaint and to submit proof that extraordinary circumstances were present and that irremediable dam-

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age would be done unless he were permitted to bring suit for refund before he made full payment of the assessed tax. The taxpayer did not amend his complaint but he filed a brief affidavit alleging only inability to pay promptly. The Government pressed for dismissal of the action. The district court decided that the action should not be dismissed (without regard to the affidavit) since it relied on the unqualified language in the *Coates* opinion. It should be remembered, however, that in the *Hanchett* case, the district court stated that if a rule other than that stated in the *Coates* opinion was required by overriding policies of taxation, it could appropriately be established by an appellate court. The issue is now before the ultimate appellate court. It is submitted that in view of the overriding policies of taxation, suits for refund of partial payments of tax should not be permitted in every case. The old rule should be the general rule. Such suits should be permitted, however, in cases where the taxpayer pleads and proves that extraordinary circumstances are present and that irremediable damage would be suffered by the taxpayer if not permitted to sue. ☆

IRS is sensitive to reputation of practitioners signing returns

WHILE THE IRS does not rely on the representations of accountants to anywhere near the degree that the English Inland Revenue relies on the work of professional accountants, the Commissioner says that IRS men cannot help being influenced by the reputations of practitioners who have prepared returns.

In conversations in connection with the IRS budget for next year, Representative James asked Commissioner Harrington: "On the subject of the tax consultant: Of course, the highly complicated tax system which has been built up in this country has brought a lot of men into the profession— and it is a profession—of legitimate tax consultant work. Many of them are lawyers, but I suppose the greater majority of them are certified public accountants who have gone into this work.

"You, I suppose, know that there are such things as ethical men in that business. Will their services in any cases, where you might say it is only necessary to sort of spot check a return, have any effect? If the return is made and signed by a known-to-be-ethical tax consultant, does that have any influence or effect on your judgment?"

To this the Commissioner replied: It would with me, if I were an agent in a community where I knew the person.

"It is the same situation, Mr. James, that you encounter when an accounting firm signs a report which goes to a bank. The bank credit man is going to be guided in his appraisal of that report by his knowledge of the reputation of that firm. That is just human nature.

"While our men are not going to deviate from our policies in making their audits, it goes without saying that when they are checking the return signed by a concern which they know to be honest and absolutely reputable they will make more spot checks than they would feel it permissible to make if they did not know the fellows who prepared it. In other words, it goes without saying that the reputation of the person preparing the return does have some effect on the man making the audit, as to how deeply he wants to dig in. He will take their statements on things, where perhaps in other cases he might want to go further."

Non-professional consultants

"While we are on that subject," said Mr. Harrington, "I want to make this observation, in case anything which has been said might be misunderstood, as to the tax consultants.

"The reputable tax consultants in the country, in the legal profession and the accounting profession, do not number enough people to possibly take care of all the taxpayers who want help. Consequently, we have in this country a large group of people who are doing a commendable job, who do not belong to either of these professions, and we welcome their help, because they are helping the taxpayers to make honest and fair returns.

"I refer to such people as the corporation bookkeepers, the bank clerks, and schoolteachers in some of the rural communities. They are people of more than average intelligence who can take this tax law and make out the simple returns. That particular group of people probably help more people in the country in the aggregate than the two professions put together, because there are so many people who do not feel that they want to go to the legal firm or the accounting firm. They do not think their problem is important enough, and they do not want to spend the money, but they will go next door to the fellow who is the bookkeeper in the factory, since they know that he has some knowledge of bookkeeping and taxes, and they will say: 'Help me out with my tax return.' Or they will go to the bank and ask somebody there. We welcome that help. That is perfectly legitimate and should not be confused with these 'shysters' who do all of this advertising and all this crooked stuff. . . ."

"These people are unlike the man who sets himself up as a legitimate tax consultant," said Mr. James. "That is the way he makes his living, by working for firms and individuals. I would think, then, that they would become known to the tax authorities in the various districts, and I would think that their decisions might be accepted, and to some extent, at least, that the burden of thorough investigation would be taken off the back of the Department. Might that not be a reasonable conclusion?"

"That is a question which has been up for a long time. We are not prepared yet to accept such returns without an audit of some kind," Mr. Harrington replied.

"Where the question of the judgment on the reputation of the tax consultant comes into play is in this way," said Mr. Harrington. "The agent is going to make the audit just the same, but he is going to make inquiry of the tax consultant, and he is inclined to accept the statements he receives from him. In other words, he knows he is honest and he is not going to dig in like he would if he did not know him, but he is still going to make the audit."

Said O. Gordon Delk, Deputy Commissioner: "There is one other thought that I might add here. Of great assistance to the Revenue Service in this system of classification and screening of returns for examination is the very common practice among the better practitioners, of whatever profession they may be, on disclosure. Notwithstanding our efforts on the tax form, there are certain elements in the form where you

can lump items. When you lump things together then you cannot get the test of proportion.

"In screening these returns one of the essential things is the relationship of cost to sales, and so on. It is there where, if it has been competently prepared, the revenue people can make these tests and decide:

'This is a fair return. There has been an adequate open disclosure.'

"Sometimes, as you have very succinctly pointed out, they will point out that:

'We have taken what is obviously a position that may look peculiar, but we have reasons.'

"And they will set those forth. In many cases we will agree and pass that return, because the reasons are so ample and there has been such disclosure that we find we can agree with it, and we may even not demand further verification.

"The good, well-trained tax practitioner is generally acquainted with these things and does this type of job in preparing a return. It makes it easier for us." ☆

New procedural decisions this month

Beneficiary of insurance policies liable for decedent's income tax. Taxpayer here was executrix of her husband's estate and also beneficiary of his insurance. Finding itself bound by Second Circuit decisions in point, the court holds her liable as transferee to the extent of the cash surrender value of the insurance for decedent's income tax deficiencies on which assessments had perfected a lien at his death. As to deficiencies for which no lien arose, the court finds her liable for a different reason. The taxable estate for estate tax purposes consisted almost entirely of the insurance. The Code gives the estate a right of action against insurance beneficiaries for their share of the Federal estate tax. As executrix, she could have enforced this right against herself as beneficiary. The Government, as a creditor of the estate, can enforce the same right. [On the question of transferee liability of insurance beneficiaries, the courts of appeal are in hopeless conflict. The Supreme Court has granted certiorari in the *Stern* case, and resolution of the conflict is expected during this term.—*Ed.*] *Jeromer,* DC N.Y., 10/2/57.

Tax Court dismisses late filing of petition [*Certiorari denied*]. The Tax Court dismissed the taxpayer's petition because it was mailed on the 91st day (received by the Tax Court on the 92nd day) after the notice of deficiency was mailed to the taxpayer. The 1954 Code provides that a taxpayer may mail a petition to the Tax Court within 90 days of the notice of deficiency. This court affirms. *Lingham-Pritchard, cert. den.,* 12/9/57.

Registered mailing of deficiency notice to last-known address sufficient to start 90-day period. On August 9, 1955 the Commissioner mailed the statutory notice of deficiency by registered mail to taxpayer's last-known address. The postman did not find taxpayer at home and, in accordance with postal regulations, left a notice that a piece of registered mail was being held at the post office. Later the IRS phoned taxpayer and was asked to forward the letter to taxpayer's office. The letter, which bore the original mailing date of August 9 was received by the taxpayer on August 23, 1955. The Tax Court held the 90-day period for the filing of a Tax Court petition began August 9, not August 23. Taxpayer was not misled about the date the Commissioner mailed the notice or the time which he had to file the petition. Thus, the Tax Court had no jurisdiction, since the petition was filed more than 90 days after August 9. This court affirms. *Teel,* CA-10, 10/15/57.

Limitations statute runs from date of allowance of credit. A tax deficiency of taxpayer's was paid by application of credits, rather than by cash. For purposes of the two-year statute of limitations on refund claims, the date on which the Commissioner signs the Schedule of Overassessments governs. Since this date was more than two years before the claim was filed, the claim is barred by the statute as to the amount credited. However, interest paid within the two-year period is refundable. *Rahr Malting Co.,* DC Wisc., 12/16/57.

Limitations statute does not bar U. S. in collecting officer's debt to corporation. Mike Jacobs, the fight promoter, had borrowed heavily from his wholly-owned corporation, Twentieth Century Sporting Club. The corporation was indebted for Federal income taxes. In a collection action to enforce the debt for the payment of the tax obligation, the U. S. is not barred by any state statute of limitations unless the claim was so barred at the time its lien arose. In determining this latter point, the court looks to the law of the forum, New Jersey, which is that loans to an officer are prohibited and not barred by ordinary limitation statutes. *Jacobs,* DC N. J., 4/57.

Tax payment prior to assessment does not start statute of limitations running. The Code provides that the statute of limitations on claims for refunds starts to run from the date of *payment* of the tax. Taxpayer here agreed to a deficiency assessment and in February, 1948, paid it. The payment was credited by the Government to a suspense account until June 25, 1948, when the Commissioner made the assessment. Taxpayer's claim for refund was filed on June 7, 1950. If the tax was paid in February, the claim, filed more than two years thereafter, was untimely. The court holds that the payment made in February, 1948, was a deposit and not a payment of tax to start the statute of limitations. The tax was not paid until at least the assessment date and therefore the claim, filed within two years of that date, was timely. *Phillip-Jones Corp.,* DC N. Y., 10/14/57.

New EPT relief can't be asserted after limitation period expires on original claim. Taxpayer filed a claim for excess profits tax relief based on a change of product during the base period. Then, after the statute of limitations had run, taxpayer asserted for the first time that it was entitled to relief because of a change in operations from a conservative to a volume sales policy. The court holds that taxpayer chose in its original application to rely upon the specific ground of change in product and cannot shift its position after expiration of the limitation period. *Burwell Motor Co.,* 29 TC No. 27.

Estimated payments on tentative return don't start statute. Taxpayer obtained an extension of time for filing its 1947 income tax return to July 15, 1948. A tentative return was filed March 15 and payments on account of the estimated tax was made at March 15 and June 15. The District Court held that a claim for refund filed within three years of the final return is timely. It said that

amounts paid on account of a tax to be computed in a return later are not "paid" until they are applied by the Collector to the tax involved. The payments here were held in a suspense account. This court affirms. *Budd Co.*, CA-3, 11/27/57.

Notice of deficiency a determination under Section 1311. If the Commissioner adopts an inconsistent position with respect to tax treatment of related persons, the statute of limitations is open for one year after the determination of one party's tax for the related party treated inconsistently to file claim. The court determines that the Commissioner's action in recognizing two minor partners as valid members of a family partnership and assessing tax on them (the Commissioner had previously refused to recognize them and had reduced their tax) was a determination opening the year of the major partner who had paid tax on this income. His claim therefore, filed within the year, was timely. *Porbeck*, DC Ark., 9/4/57.

Taxpayer bound by informal deferment; IRS has extra time for assessment. Under EPT, a taxpayer was permitted to defer payment of part of the tax for which it claimed 722 relief on Form 991. The Government then had until one year after determination of the 722 claim to assess the deferred tax. Taxpayer here reduced its 1943 EPT tax, noting on form, "per 991 for 1942." It filed a 991 for 1943 in 1946. The EPT claim was denied and tax assessed for all year. Taxpayer argued in the district court that the regular three-year rule applies to 1943 because the deferment was improper. Therefore, the Commissioner had no "extra" year. That court held for the Government and this court affirms; the IRS waived the requirement that 991 be filed when it permitted the deferment. *Sunland Industries, Inc.*, CA-9, 10/16/57.

Tax Court upheld in decision on ground not presented. Taxpayer, a real estate corporation, agreed to pay a total of $2,500 a month to its four stockholders who had obtained for taxpayer a valuable hotel lease and a renewal. It deducted the payment as rent. The Tax Court held the expenditure deductible, not as rent but as compensation for services rendered by the stockholders. The Government's position was that the payments constituted a dividend and here argues it was error for the Tax Court to decide on a ground not presented by taxpayer. The court finds that the Commissioner was not substantially harmed by the difference in nomenclature. The Tax Court determination was a finding of fact which was not clearly erronious. *Multnomah Operating Co.*, CA-9, 9/30/57.

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Tax Court can uphold Commissioner though on new theory [*Certiorari denied*]. Taxpayers were paid certain sums by their controlled corporation which they did not report as income. The Commissioner treated them as taxable dividends. The Tax Court said it was the collection by the corporation of certain receivables lent to the corporation by the taxpayers to serve as collateral for corporate borrowing; and since the taxpayers did not show their basis for the receivables the collection was fully taxable as ordinary income. One Tax Court judge had dissented because this theory had not been presented in the issues. The circuit court held that if the Commissioner's determination is correct on any theory it should be upheld, and affirmed the Tax Court. *Towers, cert. den.*, 1/6/58.

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Assessment of "forgiven" 1942 tax enjoined; no fraud shown. One-half of 1942 taxes were forgiven when Congress adopted the pay-as-you-go system. In 1953 the Commissioner assessed additional tax for 1952 and at the same time assessed the forgiven portion of taxpayer's 1942 tax, alleging fraud. The court holds that fraud in 1942 was not proven and enjoins the reassessment, the ordinary statute of limitations having run. It refuses to enjoin collection of the 1952 assessment. *Curd*, DC Fla., 12/6/57.

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Standard issues barred, though taxpayer claimed Section 722 relief. In disallowing taxpayer's claim for Section 722 relief, the Commissioner raised a standard issue and assessed a tax deficiency. The Tax Court, following its decision in *Poe*, 25 TC No. 691, held that the deficiency was barred by the statute of limitations. The Commissioner had argued that by filing the 722 petition with the Tax Court, taxpayer opened the entire tax liabliity for the year. This court affirms. *S. Frieder & Sons*, CA-3, 9/9/57.

Deficiency from Virgin Islands Finance Dept. doesn't give Tax Court jurisdiction. A notice of deficiency from the head of the Tax Division of the Virgin Island's Department of Finance does not give the Tax Court jurisdiction; there was no showing of his authority to act as delegate for the Secretary of the Treasury. *Dudley* 28 TC No. 111.

Federal tax liens have priority over mechanics' liens not reduced to judgment. A Federal tax lien was recorded after mechanics' lien statements were on file but before the mechanics' liens were reduced to judgment. The Federal tax liens were entitled to priority. The U. S. Supreme Court thus reverses the Supreme Court of Colorado. *Vorreiter*, Sp. Ct., 10/14/57.

Good faith excuses penalty for failure to sign return properly. Only one of the officers of taxpayer-corporation signed the corporation's tax return. (Two officers of a corporation are required to sign a return by the 1939 Code.) The court holds that since the return was made in good faith, no penalty is due. [The 1954 Code requires signature by only one of several specified officers or any other officer authorized to sign.—*Ed.*] *French Broad Ice Cream Co.*, DC Tenn., 9/9/57.

Rules for privately printed W-2; reproduction of other forms. The IRS sets forth specifications, size and weight of paper, colors, numbers of copies, etc., for the guidance of employers who print their own forms. Proposed substitute forms which do not meet the specifications may be submitted for approval. *Rev. Proc.* 57-38. The IRS restates its requirements governing the reproduction of various forms. It lists the forms that may be reproduced, the methods (photo offset, photocopying, etc.), the quality and size of paper, color, etc. Reproductions meeting these conditions may be used without approval. If specific approval is desired, samples may be sent for consideration. *Rev. Proc.* 57-39.

Accepted offers in compromise open to public inspection. Public inspection of accepted offers in compromise is available for a period of one year after acceptance. Copies will be made available for examination at the national office or in the office of the local District Director, whichever was the office where the offer was accepted. *Rev. Proc.* 57-30.

Declaratory judgments not available in Federal tax matters. Taxpayer sought

a declaratory judgment on whether or not it was tax-exempt and an injunction against the Director. The district court denied both the judgment and the injunction. The Declaratory Judgment Act expressly excepts controversies about Federal taxes from the jurisdiction of the district courts, and the injunction is not available since it would be part of the relief incident to a declaratory judgment. *The Jolles Foundation, Inc.,* CA-2, 12/6/57.

Amended applications for 722 relief barred by statute. Taxpayer filed timely applications for excess profits tax relief under Section 722 for its taxable years 1943 and 1944. After the statute of limitations had expired, taxpayer sought to amend the relief applications by asking for carryovers and carrybacks of increased unused excess profits credits of 1941, 1942, and 1946, based on a constructive average base period net income for each of those years. The court holds the so-called amendments to the applications made claim for relief upon an entirely new ground, different from that set forth in the timely original applications, and were therefore barred by the statute of limitations. *Feature Publications, Inc.,* 29 TC No. 35.

Tax Court judgment cannot be opened after it becomes final. On October 3, 1955, taxpayer filed a motion requesting leave to withdraw its stipulation dated September 27, 1951, and to revise the Tax Court decision entered that year pursuant to such stipulation. The motion was predicated on the alleged mistake of the parties and the fraud perpetrated on taxpayer by its president and CPA, which facts were first disclosed to taxpayer on June 4, 1954. The Tax Court held the motion was not timely and denied relief to petitioner. Noting that the Tax Court has no equity powers and that its decisions become final after a certain time, this court holds that the Tax Court had no power to review its judgment and affirms the denial of relief. *Jefferson Loan Co.,* CA-8, 11/18/57.

Agreeing to offset of tax overassessment by another's deficiency doesn't avoid interest income. A taxpayer paid the deficiency (including interest) of another person by having the amount thereof offset against his overassessment. The Service holds the taxpayer must include the full interest on the overassessment in his gross income while the interest on the deficiency may be deducted only by the taxpayer whose liability the interest represents, irrespective of any agreement between the parties. *Rev. Rul.* 57-481.

Additional day allowed if last day falls on Sunday. Where the last day prescribed under the 1939 Code falls on a Sunday, the performance of such act will be timely if performed on the next succeeding day. Accordingly the IRS revokes *Rev. Rul.* 56-177, which held it was without authority to exclude Sunday from time computations. [The 1954 Code provides that if the last day prescribed for performing an act falls on Saturday, Sunday or a legal holiday, performance the next day is timely.—*Ed.*] *Rev. Rul.* 57-512.

1099s required for soliciting agents of casualty insurance company. The Regulations provide that property insurance companies need not file information returns on payments to general agents. The IRS now rules that this exemption does not apply to soliciting agents who are without authority to write policies and merely procure applications and collect premiums. *Rev. Rul.* 57-474.

Application for extension of filing time will fix tax year. The filing by a new corporation of Form 7004, Application for Automatic Extension of Time to File U. S. Corporation Income Tax Return, establishes its annual accounting period. A change to another accounting period requires the Commissioner's approval unless the ecorporation meets the requirements of Reg. §1.442-1(c) and (d), which allow changes without permission under severe restrictions, e.g., no change within ten years, no carryovers affected, etc. *Rev. Rul.* 57-589.

Returns were fraudulent; no time limitation on transferee liability. Generally, assessments against transferee must be made within four years. Here, the taxpayers, assessed as transferees by stipulation, acknowledged the transferor's fraud. Therefore, as in all fraud cases, there is no limitation of time. One asserted transferee was found by the Tax Court to have received title to the property transferred prior to the transferror's insolvency and was therefore not liable. However, others who received property gratuitously while the transferror was insolvent, were held liable to the extent of the value of the property received. This court affirms. *Smith,* CA-5, 11/8/57.

Interest on interest due under 1939 Code. A jeopardy assessment was made against taxpayer on July 8, 1952. On November 1, 1954 taxpayer paid an amount that was finally determined to be sufficient. The court holds that because no bond was filed, under the 1939 Code interest from July 8, 1952 to November 1, 1954 runs on the amount due on July 8, 1952 including the interest and penalties then due. [Section 6601(f)(2) of the 1954 Code provides that interest will not be charged on interest. —*Ed.*] *Grimsley,* DC Ala., 10/31/57.

No interest on tax installments paid before return was due. The Revenue Act of 1951 was passed in October and affected tax rates of corporations having fiscal years ending in 1951. The Act provided that returns heretofore filed for those fiscal years were nullities, and new returns would be due January 15, the year ended April 30, 1951 in July, and had made two installment payments of the tax thereon. The 1951 Act specifically provides that these installments shall be deemed paid at the time of filing the new return. Thus, the court holds, it is clear that Congress did not intend to treat these premature payments as overpayments on which interest would be paid. While taxpayer received no compensation for the use of these funds, it does not follow that the Government is required to pay such compensation. *Crown Zellerbach Corp.,* Ct. Clms., 12/4/57.

Interest determined on overpayments resulting from Section 722 relief. Taxpayer was granted Section 722 relief, which resulted in overpayment of its excess profits taxes and correlative income tax deficiencies. Before the relief was granted, deficiencies in excess profits on standard items had been determined. After Section 722 relief was granted, these deficiencies became nullities. The taxpayer argued that it should have been allowed interest on the full 722 overpayment from payment of the tax until assessment of the deficiencies, not to the earlier date of acceptance of the deficiencies. The court agrees; interest on deficiencies ceases on acceptance but that on overassessments runs to actual assessment of deficiencies and their offset against the overassessments. *Winn-Dixie Stores,* Ct. Cls., 12/4/57.

THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

How to handle travel and entertainment expense in 1958; rules still developing

THIS SPRING the wise taxpayer will pay as much attention to setting up a good system for handling his 1958 travel and entertainment deductions as he does to assembling all his other allowable items for his 1957 return. For the Treasury is sticking to its position that item 6(a) requiring reporting of reimbursed expenses will appear on 1958 returns and a detailed answer will be required. It is widely reported that the Treasury is preparing a guide on the subject of reimbursed expenses to be published shortly.

This guide, it is to be hoped, will clear up some of the confusion over who is responsible for keeping records. Representative Mills, who as chairman of the powerful House Ways and Means Committee speaks with authority, has said that Congress wants the Treasury to concentrate its attack on the corporation making the expense account available and not to harass the employee with excessive paper work. Just how the Treasury can achieve this, particularly in dealing with close corporations (where much of the sharp practice has occurred) remains to be seen. Representative Hebert (D. La.) has introduced a bill which would prevent the IRS requiring more detailed records of these expenses than has heretofore been required.

Another proposal that would provide a reasonable rule but which, we venture to suppose, would not meet the Treasury objectives (again, particularly in the close corporation area) is the request by representatives of the American Institute of Certified Public Accountants that employees not be required to report reimbursed business expense as income if they account for it in detail to their employers. Wallace M. Jensen, Chairman of the Committee on Federal Taxation and Benjamin Grund, Chairman of the Subcommittee on Tax Administration have written to Commissioner Harrington urging modification of the announcement that all reimbursed expenses must be reported on line 6(a) for 1958.

Meantime, two simple steps can be taken. One is consistently to have as many expenses paid directly by the employer as possible. Sometimes it is a bit more convenient for the individual to pay—but he would be unwise to inflate his expenses this way. Another way is to stop the bad habit of choosing one member of a traveling group to act as bookkeeper. Here also there is an unnecessary increase in one man's accounts. Let each man report his own expenses, having the statement approved by the senior member of the group if desired.

The coincidence of the Treasury crackdown on expense accounts with the more dubious economic outlook is leading many companies to tighten up on what have become somewhat lax expense-account practices. The National Industrial Conference Board made a survey of forty-five medium-size to large companies on the action they were going to take. The survey bore out the prediction of one executive that "the current interest caused by line 6(a) will result in companies taking a closer look at their expense-account practices." On the question of providing records for employees, the survey showed that "about one out of every six companies participating . . . is considering giving annual expense statements to their employees. But only two such companies report a definite decision to prepare annual statements. One company states that its expense detail is recorded on punched cards, and preparation of annual statements will not be too difficult.

"About 10% of reporting companies," the survey found, "grant some flat expense allowances, and all such companies plan to continue their present practices.

"Flat expense allowances are granted to only a few employees, according to most of these companies. Only one survey company reports using a flat per diem expense allowance for all employees; and another grants a flat expense allowance to its salesmen based on their volume of sales. Both companies feel that it is their employees' responsibility to make a proper tax report of such funds . . . .

"Whereas three fourths of all survey companies report payment of some form of club dues, only 10% of such companies plan any changes in their present practices.

"Payment is usually restricted to the top executive level in most cooperating companies that pay club dues. One company pays club dues for men at various management levels, but its sales division is allowed the most extensive use of club memberships. In another company, club dues are paid for sales officials down to the division manager level. In some companies, the payment of dues is limited to luncheon clubs . . . .

"An increase in the payment of club dues direct by the company rather than through employee expense accounts is the only change indicated.

"Most participating companies that have company cars assigned to salesmen or other employees allow personal use of the car, providing the individual pays the out-of-pocket expense for such items as gas and oil. They leave it up to the employees to be reasonable in their use of company cars for personal use. Others require a per mile reimbursement."

Tax men, particularly those concerned with the setting of company expense account policy (or advising those responsible) will find much food for thought in the words of Henry Cassorte Smith (of the New York law firm of Webster, Sheffield & Chrystie), writing in the Harvard Business Review for January-February, 1958. In his opinion the current necessity for review of company policy presents an opportunity to take a good hard

Benjamin Harrow, editor of this department, died suddenly in Palm Beach on January 12. He was widely known and much esteemed as lawyer, CPA, and author. He will be sorely missed.

look at the abuses that have flourished in this area, to consider the demoralizing effect they have had on our self-assessment system and for business itself to insist on a sterner standard of morality in this area. In answer to the question "What should business do about these abuses of expense accounts?" Mr. Smith says:

"It seems to me that an important management responsibility is involved here. We are dealing with morality, ethics, and attitudes toward government. Moreover, this responsibility is far from an altruistic one. We have no *right* to a tax on *net* income. The government could, if it wished, revise corporate and individual income taxes to make them apply on *gross* income.

"I do not believe that the answer is more regulations and statutes. I think that it lies first in a better understanding by business of the rules relating to the deduction of travel and entertainment expenses—and especially of the spirit of these rules. Secondly, to implement this understanding, businessmen should know a little more about the best methods of handling expense accounts; ethics and good intentions mean nothing if they cannot be translated into practices and procedures." ☆

IRS attacks sale of nearly matured endowment policies

HAVE ANY of your clients asked you about a tax-saving gimmick: selling endowment policies due to mature shortly? For a long time now we have been hearing that some smart operators were making a business of buying maturing endowment policies, tempting the sellers with capital gains on the proceeds.

A case now pending in the Tax Court (*Phillips,* Docket 60084) reveals not only that the IRS is asserting ordinary income on such transactions, but also that in 1946 it was issuing rulings that gain on such a sale would "ordinarily" be capital gain. We hope that the decision will give details on the ruling; it will be most unfortunate if the Service is following *Automobile Club of Michigan* with another retroactive revocation of a ruling.

But to return to the endowment issue: taxpayers holding such policies due to mature shortly are in a difficult position. If the Commissioner is sustained in his argument that such a sale results in ordinary income, the taxpayer loses the opportunity to spread the receipt over three years under Section 72(e)(3). Under that section, the tax on a lump-sum endowment cannot be greater than it would have been had the income been included equally in the taxable year and the preceding two years.

Of course, the *Phillips* case presented some special features. The policy was sold by the owner to his law partners twelve days prior to maturity at a $250 discount from face. In another case, *Arnfeld,* now in the Court of Claims (No. 477-55), a wife claimed capital gain on the sale of an annuity contract received as a gift from her husband. Perhaps the decisions in these cases will indicate whether sales to complete strangers will be safe. ☆

Reduced estate tax prompts realty investment abroad

REALTORS REPORT considerable interest among wealthy U. S. investors in foreign realty, particularly property in Canada. Motivation for such foreign investments is believed to be in part the resulting reduction in inheritance taxes. The Code specifically exempts foreign realty from the U. S. estate tax. Of course, succession taxes will be payable, on the estate owner's death, to the country where the property is located. These rates vary from one jurisdiction to another; in Ontario and Quebec they are high because the tax rate is determined by the size of the whole estate, no matter where located. The rates in every case, however, are lower than in the U. S., permitting substantial savings in jurisdictions with lower rates. ☆

THE SPLIT-INCOME PROVISION

THE SPLIT-INCOME provision of the law is sometimes referred to as an unjustified differential or leakage in the tax base. This, of course, is incorrect in a literal sense because it does not reduce the total tax base at all. Given the situation arising from the fact that some states originally had community propery laws, and others were rapidly acquiring a strong attachment to the French and Spanish legal concepts, the split-income provisions seem to have been the best available solution.

It was certainly vastly preferable to the alternative proposal of requiring compulsory joint returns—which, if adopted, would have constituted a recurring annual tax on marriage where both spouses have income. I can think of no more anti-social and uneconomic tax proposal. Thus, though the split-income provision is not something which would be recommended to a country which had a uniform status for income and property throughout its breadth, it appears to be the best practical solution to a specific problem in this country. . . . *Dan Throop Smith,* Deputy to the Secretary of the Treasury, at the Tax Institute, Princeton, N. J.

Problem of double disallowance of T & E expenses now before the Tax Court

ONE OF THE most serious aspects of the problem of deductions for travel and entertainment expenses is the possibility of a double tax—i.e., that the expense will be disallowed to the corporation and also taxed as income to the employee. This angle was discussed by John T. Hayes, CPA in Chicago with Arthur Young & Co., at 7 JTAX 77, (and also by Arthur Hemmings at 8 JTAX 2). Mr. Hayes now writes to us calling our attention to a case on the Tax Court Docket (*Germantown Fire Insurance Co.,* Docket No. 70713) in which the taxpayer protests this kind of treatment.

The Germantown Fire Insurance Company claimed a deduction of about $10,000 for travel and entertainment expenses incurred by its president in attending conventions of groups which, the petition states, controlled profitable sources of business and in traveling to promote business with established insurance agencies, all of which involved extensive entertaining. The Commissioner allowed about $7,000 but disallowed $3,000, which the agent had determined was incurred by the president's wife.

"In many cases," Mr. Hayes points out, "the disallowance to the corporation is very unfair since, where the employee is not a major stockholder, any expense

payments to him are almost always compensatory in nature. The corporation should be allowed a deduction as compensation even if the money is deemed by the agent to have been spent on personal expense of the employee. Revenue agents have, however, been disallowing these expenses to the corporation, even though the *Faitoute Iron and Steel Co.* (11 BTA 818, *acq.* VII-2 CB 12) and *W. Horace Williams Co., Inc.* (DC La., 56-2 USTC P9839) cases have held such expenses to be deductible by the corporation. The Commissioner may finally be forced to admit his error because the Germantown Fire Insurance Company is litigating the issue. The question here is the deductibility to the corporation of travel expenses allocable to the wife of the company president.

"Even where the individual is a major stockholder, the facts often show an intent to compensate rather than to give a preferential dividend. The Service should allow the deduction to the corporation whenever such intent appears. If this taxpayer is successful, the Commissioner will then probably have to stop harassing the corporations involved and instead collect the tax from the individual alone. The primary responsibility for expense account abuses should rightly fall on the individual anyway." ☆

New decisions affecting individuals

Partner must use share of partnership's gross income for dependency gross income test. Although each of taxpayer's minor children had a distributable share from a partnership of less than $600, taxpayer is denied a dependency credit for them for 1952 and 1953 because each child's share of the gross income of the partnership exceeded the statutory maximum of $600. *McIntyre,* TCM 1957-239.

Jury finds taxpayer's domicile was with dependents; he was head of household. At issue was the location of the taxpayer's domicile. If it was in the city in which he maintained a home for his mother and sister, rather than the city in which his business activities were centered, he could claim the status as head of a household with lower surtax rates. [Under the 1954 Code, a taxpayer can be head of a household even if his home and the home maintained for his dependent parent do not coincide.—*Ed.*]The jury finds for the taxpayer. *Cockrell,* DC Tex., 11/5/57.

No alimony deduction for payments made for childrens' support. Taxpayer agreed to pay his ex-wife $125 per week and she would be responsible for the two children. Upon her remarriage, the weekly payments were to be reduced to $31.25 per child, and as each child attained the age of 21, $31.25 was to be eliminated from the payment. The Tax Court held the amount for the support of the children is identifiable and permits taxpayer to deduct only one-half of weekly payment as alimony. This court affirms. *Eisinger,* CA-9, 12/-0/57.

Wife not a thief in accepting support money from husband; extortion payments not a theft loss [*Certiorari denied*]. Taxpayer was married in New York in 1937. At that time he did not know that his wife had been previously divorced and prohibited from remarrying. When he discovered the facts in 1945, he secured an annulment *nunc pro tunc.* He claimed a deduction for moneys spent on his wife since 1937 on the novel theory that the payments were secured by larceny under false pretenses and hence constituted a theft. The Tax Court held that her acceptance of funds as a wife did not constitute a theft and the Second Circuit agreed that taxpayer did not prove that her act was theft under New York law. Furthermore, money secured by her from taxpayer, after the annulment, through extortion, by threatening ruin of his business reputation, was neither theft nor an ordinary business expense. *Bonney, cert. den.,* 12/16/57.

Ex-wife taxable on full support for herself and child. Taxpayer-husband's divorce decree required him to pay $12,000 a year to his ex-wife for her support and the support of their child. Under certain conditions her support would cease but the husband would pay $300 a month for the child. The Commissioner inconsistently taxed the wife with $12,000 but allowed only $8,400 to the husband as alimony, and the Tax Court, deciding both cases together, held that $3,600 a year was for the child and only $8,400 was alimony. This court reverses, citing *Weil* (240 F.2d 584, *cert. den.* 353 U.S. 958) that the statute taxes to the wife sums which are available for her own use or benefit whether or not she has undertaken to support the minor children. Hence, since the wife here is not required to use the $300 a month for the child, the entire amount is alimony, taxable to her and deductible by the husband. *Hirshon,* CA-2, 12/5/57.

Separation agreement incident to a divorced secured 14 years later. Bernarr Macfadden married taxpayer in 1913. In 1932 they entered into a separation agreement which provided for payments in lieu of alimony and specifically referred to a subsequent divorce action. Although he began divorce proceedings in 1933, actual divorce did not occur till years later, and then in a different suit. Taxpayer argued that the payments she received under the 1931 agreement were not incident to the 1946 divorce. The Tax Court held that since divorce was contemplated at the time of the agreement, payments made thereunder were "incident to" the subsequent divorce and were includible in the wife's income as alimony. This court affirms. *Macfadden,* CA-3, 12/19/57.

Presumption that return filed by husband creates joint liability, rebutted by wife. Generally if a husband files a joint return without objection from the wife, and she files no separate return, it will be presumed the joint return was filed with the consent of the wife. However, taxpayer wife here showed that she was separated from her husband until his death; that she did not sign or tacitly acquiesce in any joint return; that she had not filed a separate return for the same period because of a mistaken impression that the filing by her employer of a withholding tax return was sufficient. The court holds she is not liable for the tax shown on the joint return. *Groves,* TCM 1957-196.

Loss from photography deductible. Taxpayer operated a photographic studio and did professional work both portrait and outdoor. Although he abandoned the studio prior to the taxable years, he continued to do professional work at a net loss. The court finds taxpayer was engaged in trade or business as a photographer with the hope of ultimately making a profit, and holds the losses deductible. Taxpayer's other sources of income did not show him to be "a rich

man indulging in a hobby." *Eggert,* TCM 1957-221.

Vanderbilt's losses as lecturer deductible as business expenses; wife's travel expenses not allowed. Taxpayer gave illustrated lectures on travel and current foreign affairs topics for fees ranging from $300 to $1,000 per lecture. Each of these lectures included a motion picture photographed and edited by taxpayer and his wife. In the course of filming, taxpayer's wife traveled with him to Europe, did about 30% of the photography, and appeared in about 20% of the film. Taxpayer incurred a substantial net loss from his activities during the taxable year. The Commissioner disallowed the loss, contending that because of taxpayer's background of inherited wealth, and large losses over a period of years, his activities were done for self gratification and pleasure without any profit motive. The court disagrees. It finds that taxpayer's chances of eventually realizing a profit from his writing and lecturing activities were good and not remote, and holds the activities did amount to the carrying on of a trade or business. However, the wife's expenses in accompanying her husband on the European trip is held not to be deductible. In essence, her trip was a personal vacation and she did not do anything more on the trip than that which might be expected from an interested wife. *Vanderbilt, Jr.,* TCM 1957-235.

Loss on sale of house not deductible; it was a residence. A loss on sale of a house formerly used as a residence is held not deductible as a loss incurred in a transaction entered into for profit; there was no proof of a business use up to the time of sale. Moreover, there was no proof of the value of the property at the time it was alleged to have been appropriated to income producing purposes. *De Lucchi,* TCM 1957-234.

Advertising in political convention program a proper business expense. A payment by a coal company of $7,500 for the back-page space of the official program of the 1948 Democratic National Convention is held properly deductible as an ordinary and necessary business expense. The fact that the space was not used to extol the virtues of the company's product did not require a holding that the expenditure represented a political advertisement rather than a bona fide advertisement since it did tend to create goodwill and place the name of the advertiser before the audience of the medium used. *Denise Coal Co.,* 29 TC No. 61.

Can't deduct cost of survey to investigate potential new business. Taxpayer, who had promoted and developed shopping centers and residential developments, had a survey made for the purpose of determining whether he should engage in industrial developments. The court finds the expenditure was for investigating a potential new trade or business preparatory to entering it, and denies deduction as either a business expense, an expense incurred for the collection or production of income, or as a loss. *York,* 29 TC No. 60.

Legal fees deductible in part. Legal fees incurred on contract matters regarding lecturing by taxpayer, and advice and negotiations for television and advertising sales of taxpayer's services and his films are held deductible as a business expense. However, fees incurred in connection with creditors' claims against taxpayer are disallowed in the absence of proof that the claims arose from business activities. *Vanderbilt, Jr.,* TCM 1957-235.

Libel judgment deductible as business expense. In 1924, while taxpayer was a stockholder and chief executive of several newspapers he made a statement in a published interview about an employee. The employee sued for libel and won a judgment of about $2,000 which taxpayer paid and deducted in 1951. The court finds the statement was made in the course of conducting his then business and is deductible as a business expense. It points out that permitting a deduction for a private wrongdoing in the course of conducting a business, as opposed to a public wrongdoing, does not violate public policy. *Vanderbilt, Jr.,* TCM 1957-235.

Farming operations not a business; losses disallowed. Upon considering all the evidence, the court concludes that taxpayer, a retired sales manager, was not engaged in operating a farm for profit or as a trade or business so as to be entitled to deduct a loss from such operations. He had bought the place years before and lived on it after his retirement. He lost $3,000 to $4,000 a year; he made sales of less than $100 each year though he used some produce himself. *McGhee,* TCM 1957-248.

Timber "faller" allowed part of auto expenses. Taxpayer, a timber "faller," used his car to travel between his home and the logging site, and to transport tools and equipment. He claimed about $600 cost of operating the car; the Commissioner disallowed all but $90. The court allows $150, since this use of the car was not only for commuting, but also in his trade. *Canclini,* TCM 1957-245.

Tree loss by disease or insect attack not a casualty loss. Loss arising from the death of a tree as a result of disease or attack by insects is not an allowable deduction as a casualty loss, a loss is not a casualty unless it happens suddenly. *Rev. Rul.* 57-599.

Right to standard deduction not affected by disallowance of "business" expenses [*Acquiescence*]. Improperly taking deductions from gross income in arriving at adjusted gross income has no effect on the election to take the standard deduction. Accordingly, though taxpayer claimed items as business expenses which the court found could have been taken only as itemized deductions, he did not forfeit his duly elected standard deduction. *Miller,* 26 TC 151, *acq.* IRB 1957-49.

Regulations limiting dividend credit invalid. Section 34 of the 1954 Code limits the dividends received credit to 4% of taxable income. The Regulations §1.34-2(a) impose the limitation of 4% of ordinary income where the alternative tax on capital gains is applicable. Another district court now holds this regulation invalid as being in conflict with the statute. *Cruickshank,* DC Calif., 12/27/57. Similarly *Schultz,* DC Fla., 11/27/57.

Pension to policeman's widow not exempt disability pay. Taxpayer is the widow of a Washington, D. C. policeman. Her husband was about to be retired for disability, but died before the necessary procedural steps were completed. The pension paid to taxpayer, as the widow of a deceased policeman, is the same whether he was retired for disability or died of natural causes. Therefore, the court finds the pension was not excludable as a disability payment. *Riley,* Ct. Clms., 12/4/57.

CORPORATE & PERSONAL PROBLEMS IN

Taxation of compensation

EDITED BY JOHN P. ALLISON, LL.B.

Three common types of pension plan suitable for very small companies

TOO MANY people think that pension plans are for big companies only. Even very small companies, however, frequently would benefit from the certainty of a pension plan and can afford the relatively fixed commitment it entails. These companies not only can manage such a plan, but can take their choice of several different ways of handling it. These facts were brought out very clearly by Robert S. Swaim, Vice President of the First National Bank of Chicago, at the recent 26th Mid-Continent Trust Conference in New Orleans. He told the conference of the varied opportunities retirement trusts provide to smaller trust departments in banks. We bring you his comments on plans for employers of few workers, condensed from the complete report of his talk in Trusts and Estates.

"Take the case of a company with ten to 20 employees," Mr. Swaim said, "a fairly stable group with relatively little turnover. There are at least three corporate trust methods of handling that size pension plan.

"If the employer directs the trustee to purchase an insurance policy on the life of each of these employees, we have an individual policy insured plan. The policy is roughly the same as individuals buy for the protection of their families, except that instead of a $1,000 or $5,000 policy, we buy one that will accumulate a large enough cash surrender value by the time the employee reaches age 65, to be converted under one of its options into a paid-up annuity equal to the employee's pension. One objection to this is that it would take a policy of much larger face amount to build up an adequate cash value for an employee who is 55 years old when the plan is installed than it would if he were only 35 or 40. As a result, the insurance companies usually issue a special form of policy in which the death benefit is scaled down to one hundred times the amount of each month's pension benefit so that an employee who ultimately is going to get a pension of $100 a month will have a $10,000 life insurance policy.

"The ownership of the rights and privileges under these policies must under our tax laws be vested in a trustee. The employer cannot take a tax deduction for his contributions under the plan if he is the owner of the policy and the employee cannot be the owner because he would be taxed with the premiums as additional compensation if he were. While it is true that many of these plans use one or more individual trustees, a corporate trustee provides both continuity of existence for the long-term ownership of these policies and also imputes a certain prestige to the plan in the minds of the employees.

"One of the defects of this form is that all of the reserves of an employee are buried in the cash value of the policy. If he quits working for this employer before retirement, his policy serves no purpose in providing pension benefits to other employees except by surrendering the policy for its cash value; the cost of surrendering this form of insurance is relatively high. Even if the employee dies, the cash value is dissipated in the death benefit.

Additional deposit plan

"To solve this problem some insurance companies issue their ordinary life policies for these purposes even though that policy will not have a sufficient cash value at retirement to support the full pension. However, they will agree to accept the deficit in the cash value as an additional deposit at the time of retirement in order to provide the full pension benefit under their policy. This deficiency is provided by running a Trusteed Investment Account parallel to the insurance policy during the employee's career. As each annual contribution is made to the trust, a portion of it is paid to the insurance company as a premium and the balance is retained in the investment account of the trust, where the income accumulates until the employee retires when it is then transferred to the insurance company.

"In the meantime, if the employee dies, his beneficiary still receives the death benefit under the policy but the excess reserves that have been held in this parallel trust are available to help carry the cost of future pensions to the rest of the employees in the plan. In the same way, if the employee leaves or is discharged, not all of his reserves are buried in the cash value of the policy and the portion that is held in the trust may be retained there without surrender expense to help carry the cost of future pensions to other participants.

"This modification of an individual policy insured plan requires the use of an active trust with all the incidents of custody, investment supervision, accounting and distributions called for by a normal trust.

Deferred purchase plan

"A third way of using an individual policy plan is to defer the purchase of any insurance contract as long as the employee continues working. In the meantime the funds that would otherwise be used for premium payments are accumulated in a trust, invested in a diversified list of investments and the income accumulated until the employee retires, when a single premium immediate annuity is purchased for him at then-current premium rates, from which his pension will actually be paid.

"This plan gives to the retirement program the greater flexibility of a trusteed type of diversified investment portfolio, the opportunity of capital appreciation in the investments held and the elimination of any surrender expense in the event of an employee's resignation or discharge before retirement. It is also a means of reducing or eliminating death benefits from a program under which those benefits are not particularly desired. It again offers the use of trust services for relatively small pension groups.

"That these three methods of funding pension plans covering a relatively small number of lives are widely used is shown

by the fact that out of the 35,000 approved plans, approximately 13,500 are of the so-called individual policy insured type, and they average approximately 40 lives per plan.

"The other methods of funding pension programs through insurance involve several forms of group annuity contracts. These group policies can be issued directly to the employer even though they are for the purpose of his pension plan and, therefore, do not require the use of an intervening trust. Generally speaking, they are applied in the case of larger employee groups. Insurance company figures indicate that group plans in force at the end of 1956 averaged 600 to 1,000 lives per policy. ☆

Rules published on setting up compensation plans

THE GOVERNMENT Printing Office now has for distribution a 49-page pamphlet containing the rules and procedures for setting up and operating tax-exempt pension, profit-sharing, and stock bonus plans. Also included are rules for obtaining qualification of such plans under Section 401(a).

Ask for "Pension trust procedures and guides for the qualification under Section 401(a) of the IRC of 1954," catalog No. T22.19:P 38/2. Price: 25c. Order from: Supt. of Documents, Govt. Printing Office, Washington 25, D. C. ☆

New decisions

Reynolds' employee profit-sharing not deductible [*Certiorari denied*]. Under a plan begun in 1912 and designed to encourage selected employees to invest in the stock of the company, the Reynolds Tobacco Company distributed part of its annual profits to officers and other employees in proportion to the stock they owned. The court disallows any deduction for the years 1940-48 since the distributions were not purely for services and were not measured by the value of the services. The corporation had regarded these payments as dividends, before and during the years in question, when it computed the base for the excess profits tax, the undistributed profits tax and social security and withholding tax. It also considered them as dividends under the wage-stabilization laws, in SEC reports, and in state income tax returns. The court notes that a partial deduction was allowed by the Tax Court (TCM 1956-161) for the year 1949 but a new bylaw in that year considerably changed the plan. *Reynolds Tobacco Co.*, Ct. Cls., *cert. den.*, 12/9/57.

Trustee can't separate services to qualify as long-term compensation. In determining whether a trustee in a reorganization proceeding received in one year more than 80% of the total compensation, "total compensation" is held to be the total amount paid to him in his capacity as trustee under one appointment. As a trustee, he is not permitted to separate his compensation for each separate activity so as to qualify for the benefits of income spreading, even though a local court in a nontax proceeding did divide his services into two separate projects for determining the amount of allowable compensation. *Shaffer*, 29 TC No. 23.

Additional contributions to meet certain deficits in pension plan may be currently deductible. Additional contributions by an employer to meet a deficit in an employees' pension plan may be currently deducted if the deficit results from a valuation of the trust assets using the same assumptions as were used in the previous annual valuations. However, if the revaluation is based upon more conservative assumptions than were previously used, the deficit represents a supplementary cost of prior service credits and should be so treated; i.e., only one-tenth may be deducted each year until the deficit is made up. *Rev. Rul.* 57-550.

Nonforfeitable contributions to nonqualified trusts currently taxable to employees. Contributions by an employer to separate and independently controlled nonqualified trusts for each employee are currently taxable to the employees in the year contributed because such contributions convey fully vested and nonforfeitable interests. *Rev. Rul.* 57-528.

IRS will permit revaluation of employees' trust assets to reflect market values. An employee's trusteed pension plan which had previously valued its assets at cost proposes to add to the cost of marketable stocks part of the appreciation. The revaluation for the purpose of computing the amount of employer contributions necessary will not, the IRS rules, adversely affect the qualification of the plan. The new method of valuation must be consistently followed and there must be no danger of underfunding. *Rev. Rul.* 57-549.

Plan may be disqualified if low-paid employees withdraw heavily. A qualified employees' trust permitted limited withdrawals by members. The IRS rules that if withdrawals are made in proportionately greater amounts by low-paid employees, the plan may be disqualified should withdrawals result in the plan becoming discriminatory. *Rev. Rul.* 57-587.

Federal employee's pay, withheld pending clearance, is "back pay." An amount received by a Federal civil employee in settlement of a claim filed for compensation for the periods during which he was in a leave status pending completion of his security clearance, may be treated as "back pay" if it is more than 15% of his gross income for the year in which received. *Rev. Rul.* 57-566.

Salesman cannot isolate particular sales for income-spreading benefits. Taxpayer was employed as Washington sales representative for a manufacturer of automotive equipment. Services which he rendered over 37 months in the sale of 240 tanks to the Chinese government were held by the Tax Court to be part of his general duties. It could not be isolated as a separate employment for purposes of qualifying the compensation under Section 107(a). This court affirms. *Reynolds*, CA-4, 11/7/57.

Insurance salesmen are not retail commission salesmen. The provisions of Section 3402(j) which permit an employer not to withhold on remuneration other than cash paid to a "retail commission salesman" do not apply to insurance salesmen. The Regulations define retail commission salesmen as sellers of merchandise and insurance is not merchandise. *Rev. Rul.* 57-551.

Salary continuation was gift, not taxable to widow [*Nonacquiescence*]. Taxpayer's husband was an 80% stockholder and president of a corporation. After his death in 1942 it continued his salary, paying it to his widow for over two years. The Tax Court held that the payment was a gift not taxable to her. (Acquiescence 1950-2 CB 1 withdrawn). *Aprill*, 13 TC 707, *nonacq.* IRB 1957-45.

MANAGEMENT OF THE

Professional tax practice

AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

What to charge for doing small individual return?

ONE OF THE most pesky problems faced by tax men, and they all have it, is the request to handle the return for an individual with a small income. Usually the taxpayer is a friend, an employee of a client, or worse, a friend of a friend. Usually, the practitioner hates to do these jobs. They take time, and the taxpayer usually wants him to gather the facts as well as fill in the return.

This being the case, we were fascinated by the publication recently of a suggested fee schedule for such work. The schedule, printed below, was prepared by an affiliate of the National Society of Public Accountants, and published by them without endorsing or rejecting the figures. Here they are:

Personal returns—basic (wages only)

	Federal	*State*	*Both*
Form 1040A	7.50		
Short Form—1040 or 540 (Table)	7.50	7.50	10.00
Long Form—1040 or 540 (Standard)	10.00	10.00	12.50
Long Form—1040 or 540 (Itemized)	12.50	12.50	17.50

(No Separate Schedules)

Personal return income schedules

Salaries and Wages Each Employer over 3	1.00
Dividends—Schedules A & J	7.50
Interest	3.00
Interest—Each item over 3	1.00
Pensions & Annuities—Schedule E (each)	5.00*
Rents & Royalties (each)	5.00
Determination of Depreciable Basis for New Property	10.00*
Schedule H-2 (Per item)	3.00
Retirement Income Credit	10.00*

Other Income Schedules As Required

Personal return deduction schedules

Transportation Expenses	5.00
Outside Salesmen Expenses	5.00
Sick Pay Exclusion	5.00
Carrying Charges—Each item	3.00
Medical Expenses	3.00
Child Care	3.00
Casualty Losses	3.00

Other Deduction Schedules As Required

Business & Fiduciary return

Single Proprietorship (Schedule C or 1040F)	20.00*
Partners Distributable Share (Per item)	3.00
Partnership Form 1065 & 565	50.00*
Self-Employment-Sch. C-3 (Ministers, etc.)	5.00
Corporation—Form 1120	50.00*
Fiduciary—Form 1041	50.00*

Sales & exchanges

Stocks & Bonds	5.00*
(Additional for each sale over 3)	1.00
Personal Property & Real Estate	10.00*
Exchanges	15.00*
Personal Residence (Section 1034)	15.00
Installment Sale	15.00
Each year thereafter	7.50
Capital Loss Carry-over	5.00
Bad Debt	7.50
Alternative Tax Computation	10.00
Involuntary Conversion	10.00

Declarations

Based Upon Prior Years Income	3.00
Replacement of Lost Declaration	3.00
Computed	5.00

Foreign jurisdiction

Other State & Territorial	10.00
U. S. Possessions—Form 1040E	10.00
Credit For Tax Paid to Other State or Foreign Country	10.00
Section 911 Income Schedule	10.00

Other service

Head of Household & Surviving Spouse Determination	5.00
Claim for Refund—Form 843	20.00*
Dept. of Employment Refund Claim —DE 1964	3.00
Statement Claiming Refund Due On Behalf of Deceased Taxpayer	5.00
Extension of Time to File	10.00
Correspondence	3.00
Duplicate Returns—Prior Years	3.00
Affidavit for Late Filing	5.00
Out of Pocket Advances	@ Cost

*Denotes "and up"

Calif. lawyers & CPAs agree on peace program

THE CALIFORNIA Society of CPAs and the California Bar Association have formed the California Conference of Lawyers and CPAs, for the main purpose of ironing out difficulties which may arise in practice involving the two professions. It will be remembered that California is the scene of the now-famous *Agran* litigation involving the alleged unlawful practice of law by a CPA. Considerable heat, expense, and ill-will was generated in that case, so the present apparently amicable development is of more than routine significance.

The new Conference agreed to keep their problems in their own back yard as much as possible. As The California CPA Newsletter described the development:

"The Bar's committee said the California Bar will not submit questions referring to the practice of law to any agency outside California, and it believes the Bar will not institute or participate in litigation or disputes between members of the two professions without such differences first being referred to the joint committee. Similarly, the CPA committee recommended to the Board of Directors that the Society take no part in litigation of this type without referring the matter to the California Conference, unless the Bar shall have instituted litigation without referring it to the Conference of Lawyers and CPAs." ☆

Don't forget to renew your Treasury card

DON'T FORGET that Treasury Cards issued after December 31, 1951, expire at the end of five years. The IRS has asked us to remind practitioners that many cards are expiring currently and must be renewed if the individual desires to continue to practice before the Treasury. Applications for renewal of enrollment cards may be made out any time during a 24-month period, commencing twelve months before, and ending twelve months after the expiration of an enrollment card; that such applications must be filed on Form 23A in the Office of the District Director in which the applicant conducts his practice, and that forms can be obtained at such office. ☆

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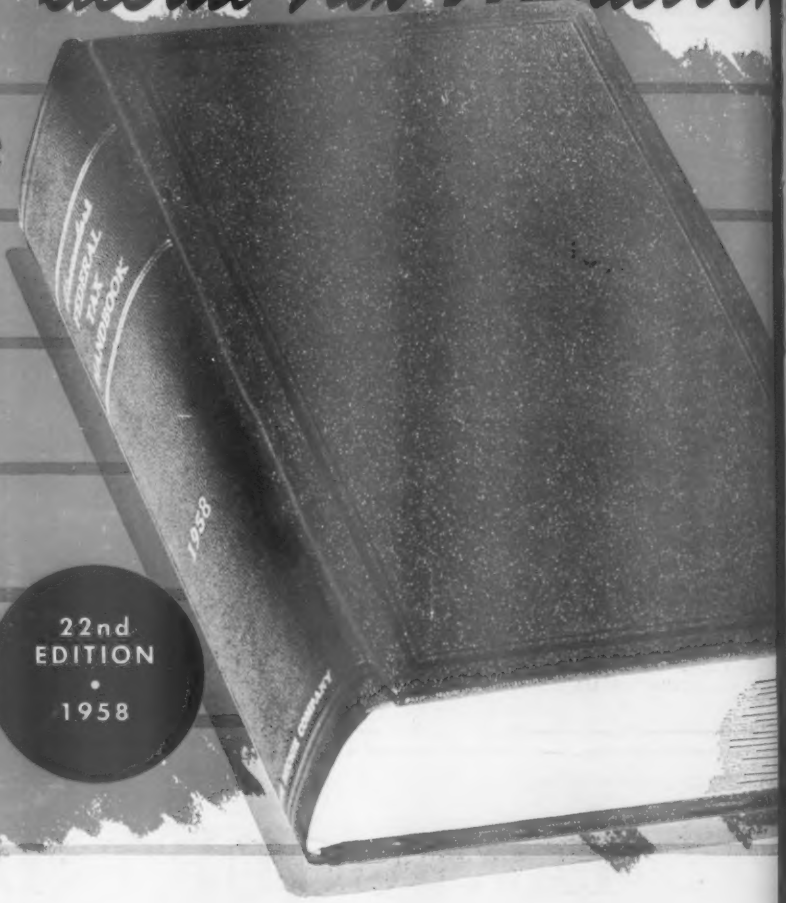

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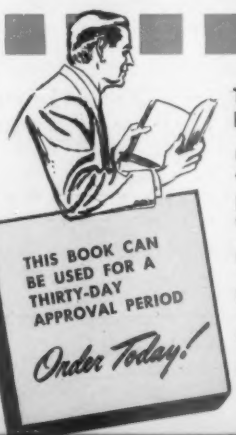

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